Schooling Congress: The Current Landscape of the Tax Treatment of Higher Education Expenses and a Framework for Reform

Stuart G. Lazar
*University at Buffalo School of Law*

Follow this and additional works at: [https://digitalcommons.law.buffalo.edu/journal_articles](https://digitalcommons.law.buffalo.edu/journal_articles)

*Part of the Taxation-Federal Commons, and the Tax Law Commons*

**Recommended Citation**
Available at: [https://digitalcommons.law.buffalo.edu/journal_articles/254](https://digitalcommons.law.buffalo.edu/journal_articles/254)
SCHOOLING CONGRESS: THE CURRENT LANDSCAPE OF THE TAX TREATMENT OF HIGHER EDUCATION EXPENSES AND A FRAMEWORK FOR REFORM

Stuart Lazar

2010 Mich. St. L. Rev. 1047

TABLE OF CONTENTS

I. INTRODUCTION ........................................................................................................ 1048

II. THE BUSINESS EXPENSE DEDUCTION ................................................................. 1053
   A. Introduction ............................................................................................................. 1053
   B. Historical Perspective ............................................................................................. 1057
      1. The Early Years .................................................................................................... 1057
      2. Between Hill and Regulatory Guidance ................................................................ 1060
      3. The 1958 Regulations .......................................................................................... 1063
      4. The Current Regulations .................................................................................... 1066
   C. Critiquing the Current Regulations ...................................................................... 1068

III. TAX INCENTIVES FOR HIGHER EDUCATION EXPENSES FOR
     INDIVIDUALS ........................................................................................................... 1074
   A. Tax Incentives for Current Expenses—The Ghost of Christmas Present ................ 1075
      1. Hope Scholarship Credit and Lifetime Learning Credit ...................................... 1075
      2. Deduction for Higher Education Expenses ....................................................... 1081
      3. Exclusion for Scholarships and Fellowship Grants ............................................. 1083
      4. Exclusion for Employer-Provided Educational Assistance Programs .................. 1086
   B. Tax Incentives for Future Educational Expenses—The Ghost of Christmas Future ...... 1089
      1. Exclusion for Earnings of Qualified Tuition Programs ....................................... 1089
      2. Exclusion for Earnings from Education Savings Accounts ............................... 1094
      3. Exclusion for Interest on United States Savings Bonds ..................................... 1097
      4. Relief from Penalties for Withdrawals from IRAs .............................................. 1099
   C. Tax Incentives for Prior Educational Expenses—The Ghost of Christmas Past ........ 1101
      1. Deduction for Interest on Qualified Education Loans ....................................... 1101
      2. Exclusion for Student Loan Forgiveness ............................................................. 1105

* Associate Professor of Law, University at Buffalo Law School. The author would like to thank Elizabeth M. Salzman (J.D. 2011, Buffalo Law School) for her tireless help on this article.
Education may be a cornerstone of our society, but the tax treatment of higher education expenses does not appear to have resulted from an intellectual exercise that would make our nation's educators' proud. The Internal Revenue Code' provides two separate, but equally unsatisfying, routes that allow taxpayers to offset their income with the costs of higher education.

Where an individual can reduce her tax liability while receiving an education, the effect is to reduce significantly the cost of that education. This “subsidization” is greatly needed as higher education costs have generally risen faster than the rate of inflation. Between 1976 and 2006, college tuition and fees generally rose by more than twice the rate of inflation. For the 2009-2010 academic year, the average cost at public two-year institutions was $2,544 per year, while the average cost at public and private four-year institutions was $7,020 and $26,273 per year, respectively.

1. Unless otherwise defined herein, the term “Code” refers to the Internal Revenue Code of 1986, as amended. References to a “Section” refer to a Section of the Internal Revenue Code. References to the “Service” refer to the Internal Revenue Service.

2. Students’ struggles to pay the costs of higher education are not new. See Note, Federal Tax Incentives for Higher Education, 76 HARV. L. REV. 369 (1962) (explaining students with the ability to do college work have been forced to forgo higher education because of an inability to pay the cost).

3. See STAFF OF JOINT COMM. ON TAX’N, JCX-35-08, PRESENT LAW AND ANALYSIS RELATING TO TAX BENEFITS FOR HIGHER EDUCATION 30 (Comm. Print 2008).

Increased costs have made the decision to pursue education beyond high school resemble other investment decisions. It, however, is an investment that provides good returns. In 2005, the median income for a full-time year-round worker in the United States with a high school diploma was $31,500. Workers with a four-year college degree had median earnings of $50,900 (a sixty-two percent increase). In 2008, median earnings for workers with a bachelor’s degree were almost sixty-five percent more ($33,800 v. $55,700) than those with solely a high school diploma. For those with greater levels of education, the disparity was even greater. In 2005, median earnings for those with a master’s degree were more than eighty-one percent above high school graduates. In 2008, these more educated workers had median earnings that were almost twice that of their high-school counterparts. In 2005, the median income of workers with professional degrees ($100,000) was more than sixty percent higher than those with a master’s degree ($67,300), and more than three times greater than that of high school graduates ($31,500). In 2008, those with professional degrees earned almost fifty percent more than those with master’s

5. One recent study notes this statement is a subject of controversy: Questions have intensified about whether going to college is worthwhile and whether it is appropriate to encourage young people who are on the fence about continuing their education after high school to attend college. We believe it is critical that more people be in a position to examine for themselves the evidence of the benefits of a college degree, rather than relying on the opinions of others—opinions that are too frequently grounded in ideology and anecdotes rather than evidence. It is both reasonable and constructive to ask whether and for whom the expense of postsecondary education is a good investment.

See Sandy Baum et al., College Board, Education Pays 2010: The Benefits of Higher Education for Individuals and Society 6 (2010), available at http://trends.collegeboard.org/downloads/Education_Pays_2010.pdf [hereinafter Education Pays 2010]. From a financial standpoint alone (i.e., not including other benefits of higher education), the authors conclude the costs of education are outweighed by the benefits. "If the earnings of all adults at each level of education are considered—instead of only those working full-time year-round—the typical four-year college graduate makes up for time out of the labor force and for paying tuition by age 30." Id. at 13.


7. Id.


9. Education Pays 2007, supra note 6, at 9. The median income of workers with a master’s degree was $61,300. Id.

10. Education Pays 2010, supra note 5, at 11. Workers with a master’s degree had a median income of $67,300. Id.

11. Education Pays 2007, supra note 6, at 9. The median income of workers with a professional degree was $100,000. Id.
degrees, and almost three times as much per year as high school graduates.12 Studies of income data from both 2005 and 2008 show that median earnings increased for each level of education attained.13 Higher annual earnings translate into higher lifetime earnings for those with advanced degrees. Based on median income data from 2005, an individual with a bachelor’s degree could expect to earn about sixty-one percent more over a 40-year working life than the typical high school graduate.14 The lifetime earnings differential between those with a professional degree and those with a bachelor’s degree was almost eighty percent, with the differential between those with a professional degree and a high school diploma being approximately 187 percent.15 Based on 2008 median earnings, people with a bachelor’s degree are expected to earn sixty-six percent more over their lifetimes compared to high school graduates.16 Those with professional degrees are expected to earn 66 percent and 174 percent, respectively, more than those with bachelor’s degrees and high school diplomas over their lifetimes.17 Although the income gap between those attaining higher levels of education and those without had decreased slightly from 2005 to 2008, the earnings differential between higher-educated and less-educated workers has been consistent (and has generally grown) over time.18

12. EDUCATION PAYS 2010, supra note 5, at 11. Workers with a professional degree had a median income of $100,000. Id.
14. EDUCATION PAYS 2007, supra note 6, at 10.
15. Id.
16. EDUCATION PAYS 2010, supra note 5, at 12.
17. Id. For a clarification of how this disparity was calculated, see infra note 18.
18. A Census Bureau report noted:
   [In] 1975, full-time, year-round workers with a bachelor’s degree had 1.5 times the annual earnings of workers with only a high school diploma. By 1999, this ratio had risen to 1.8. Workers with an advanced degree, who earned 1.8 times the earnings of high school graduates in 1975, averaged 2.6 times the earnings of workers with a high school diploma in 1999.

   The calculations . . . are based on earnings of individuals working full-time year-round. Because the proportion of adults working full-time year-round increases with education level (for example, 67% of college graduates and 55% of high school graduates between the ages of 45 and 54 worked full-time in 2008), the lifetime earnings differentials would be larger if all adults—or all adult workers—were included in these calculations.

EDUCATION PAYS 2010, supra note 5, at 12. The rate of employment is also affected by education level. As provided in one recent study:
   In 2009, with an average annual unemployment rate of 7.9% for individuals ages 25 and older, unemployment had risen sharply for all levels of educational attain-
Current law provides two ways for a taxpayer to offset her income with expenses incurred while pursuing higher education. First, where amounts spent on education qualify as an "ordinary and necessary business expense," a taxpayer will be entitled to deduct such expenses in computing her taxable income ("Business Expense Deduction"). However, the Service's current interpretation of the Business Expense Deduction is more restrictive with respect to education expenses than with respect to other expenditures.

The second, and more limited, route to obtaining a tax subsidy arises from certain tax incentives enacted for higher education expenses ("Tax Incentive Provisions"). These incentives include exclusions from gross income. The 4.6% unemployment rate for those with at least a four-year college degree was 5.1 percentage points lower than the 9.7% unemployment rate for high school graduates.

In 1999 and 2000, with low overall unemployment rates of 4.0% and 4.2%, respectively, the gap between the unemployment rates for college graduates and high school graduates was 1.7 percentage points.

From 1992 through 2009, the annual unemployment rate for individuals with some college but less than a four-year degree was between 0.7 and 1.7 percentage points lower than the unemployment rate for high school graduates.

Id. at 20.

19. See I.R.C. § 162 (2006); Treas. Reg. § 1.162-5 (as amended in 1967). Treasury Regulation §1.162-5 sets forth the requirements for deducting education expenses, but never defines "education" or "educational." The text of the regulations focuses on courses of formal instruction such as "refresher courses or courses dealing with current developments as well as academic or vocational courses." Treas. Reg. § 1.162-5(c)(1). The examples discuss refresher courses, courses dealing with current events, courses within degree programs and entire degree programs. Treas. Reg. § 1.162-5(b)(2)(iii), Exs. (1)-(3); Treas. Reg. § 1.162-5(b)(3)(ii), Exs. (1)-(3); Treas. Reg. § 1.162-5(e)(2), Exs. (1)-(3). However, the courts have held that education has a "broad commonsense meaning." See, e.g., Boser v. Comm'r, 77 T.C. 1124, 1130 (1981) (allowing an airline pilot to deduct some of the cost of flying his own airplane to and from work as an educational expense); Voight v. Comm'r, 74 T.C. 82 (1980), nonacq. 1981-2 C.B. 3 (holding that a social worker could deduct the cost of her own psychoanalysis as an educational expense). In Lage v. Commissioner, 52 T.C. 130, 134 (1969), the court stated that "['e']ducation' includes not merely instruction in a school, college, university, or a formally conducted training program, but embraces the acquiring of information and knowledge from a tutor. . . . It is clear that the deduction for educational expenses is not limited to formal or institutional education." Id. (citations omitted).


21. The order in which this Article discusses these two differing routes is intentional. Many of the provisions of the Code categorized as Tax Incentive Provisions specifically are inapplicable where the taxpayer is entitled to a deduction under another Code provision. In other words, taxpayers entitled to a Business Expense Deduction are required to take such
income for certain amounts used to pay for higher education expenses, as well as a number of deductions or credits for taxpayers who make such expenditures. While providing incentives for higher education is a worthy goal, the Tax Incentive Provisions consist of a hodgepodge of confusing statutes that fail to meet their stated objectives.22

The correlation between education and compensation—i.e., the more education one has, the more one earns—should be properly reflected in the tax code.23 More specifically, the Business Expense Deduction should be revised to provide similar tax treatment for education expenses as is afforded other business expenses.

This Article will discuss the tax treatment of higher educational expenses.24 Part II traces the history of the Business Expense Deduction with respect to education expenses leading to the Service’s current interpretation, and provides criticism of the current law in this area. Part III discusses the myriad of Tax Incentive Provisions set forth in the Code, and it briefly discusses some of the concerns associated with those provisions. Part IV provides a framework for revising the Business Expense Deduction in connection with higher education expenses, providing guidelines for when such expenses should be currently deductible and when capitalization and amortization should be required. Part V concludes the Article.

At this point, I should note what this Article is not attempting to accomplish. This Article does not attempt to address generally whether the government should subsidize such education. Elected officials have, for deduction rather than utilizing a Tax Incentive Provision—regardless of which provides the taxpayer with a greater benefit.

22. See infra Section III.D.
23. This belief is supported by the statistics referred to in this Article, as well as those found in numerous other authorities. However, the author is cognizant of the words of Mark Twain that “‘[t]here are three kinds of lies: lies, damned lies, and statistics.’” Mark Twain, Chapters from My Autobiography—XX, 185 N. Am. REV. 465, 471 (1907). For a different view of the correlation between higher education and income, see Joseph M. Dodge, Taxing Human Capital Acquisition Costs—Or Why Costs of Higher Education Should Not Be Deducted or Amortized, 54 OHIO ST. L.J. 927 (1993).

24. In his article regarding the deductibility or amortization of higher education costs, Professor Dodge excludes discussing the treatment of pre-college expenses stating that “because education is available free of charge up through the twelfth grade, the amortization issue will be deemed to pertain only to college, graduate and professional school, and postsecondary vocational education.” See Dodge, supra note 23, at 928 n.1. This Article similarly is limited to the tax consequences of post-secondary education expenditures. In addition to Professor Dodge’s rationale, the fact that all states require, with certain exceptions, that children attend school until at least the age of sixteen places education below the college level in a different category than education that is purely voluntary and unavailable free of charge. See Digest of Education Statistics: 2009 Tables & Figures, Table 166, NAT’L CENTER FOR EDUC. STATS., http://nces.ed.gov/programs/digest/d09/tables/dt09_166.asp (see figures in the 2008 compulsory attendance column) [hereinafter Education Statistics]
years, supported higher education in this country. Nor is it an attempt to end the debate on whether incentives for higher education should be provided through the tax code. Rather, this Article attempts to discuss the current and historical tax treatment of higher education expenses and to provide a system that more properly matches a taxpayer's income with the associated educational expenses.

II. THE BUSINESS EXPENSE DEDUCTION

A. Introduction

Section 162(a) provides that "[t]here shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." There is no specific statutory provision governing the deductibility of education expenditures. Whether

25. See Thomas J. Kane, Beyond Tax Relief: Long-Term Challenges in Financing Higher Education, 50 NAT'L TAX J. 335, 335 (1997) ("In his 1997 State of the Union address, President Clinton declared educational reform the top priority of his second term. Indeed the Administration's agenda for higher education [was] ... to ... make the 13th and 14th years of education—at least two years of college—just as universal in America by the 21st century as a high school education is today."); see also William Jefferson Clinton, 1997 State of the Union Address, WASH. POST, Feb. 4, 1997, http://www.washingtonpost.com/wp-srv/politics/special/states/docs/sou97.htm.

In his 2009 State of the Union address, President Obama made a similar pledge regarding education stating:

It is our responsibility as lawmakers and educators to make this system work. But it is the responsibility of every citizen to participate in it. And so tonight, I ask every American to commit to at least one year or more of higher education or career training. This can be community college or a four-year school; vocational training or an apprenticeship. But whatever the training may be, every American will need to get more than a high school diploma. And dropping out of high school is no longer an option. It's not just quitting on yourself, it's quitting on your country—and this country needs and values the talents of every American. That is why we will provide the support necessary for you to complete college and meet a new goal: by 2020, America will once again have the highest proportion of college graduates in the world.


26. Although, in Section III.D., this author discusses eliminating or significantly revising the Tax Incentive Provisions, the proposal set forth in Part IV can be effectuated in conjunction with any tax incentive provisions that Congress wishes to retain. The author approaches the Tax Incentive Provisions in a manner similar to Professor Schenk, who noted that "Congress has elected to subsidize higher education through the tax system and in this Article we do not question that judgment." Deborah H. Schenk & Andrew L. Grossman, The Failure of Tax Incentives for Education, 61 TAX L. REV. 295, 298 (2008).

such expenditures qualify for the Business Expense Deduction is a question left for the regulations.\textsuperscript{28} Notwithstanding the foregoing, education expenditures will not qualify for the Business Expense Deduction unless they satisfy both the statutory language of Section 162 and the requirements of the regulations.\textsuperscript{29} While a complete discussion of Section 162 is beyond the scope of this Article, it is important to note that Section 162 requires that the amounts paid or incurred\textsuperscript{30} during the taxable year must be “ordinary and necessary expenses” paid or incurred in connection with “carrying on” a “trade or business.”\textsuperscript{31}

The seminal case discussing the ordinary and necessary requirement is \textit{Welch v. Helvering}.\textsuperscript{32} In that case, a grain commission agent, who had previously been an officer in a corporation engaged in the grain business, made payments to the corporation’s creditors following its emergence from bankruptcy. The Court held that, because the payments were made for the purpose of improving the taxpayer’s credit and standing in the industry and reestablishing business relations with the corporation’s customers, the payments were not deductible as ordinary expenses. The Court bifurcated the phrase “ordinary and necessary” into its two component parts.\textsuperscript{33} It concluded that an expenditure was necessary if, in the judgment of the taxpayer, such expenditure was “appropriate and helpful” in the development of its business.\textsuperscript{34}

\textsuperscript{28} Treas. Reg. § 1.162-5 (as amended in 1967); \textit{see also} Weiszmann v. Comm’r, 52 T.C. 1106 (1969), \textit{affd. per curiam}, 443 F.2d 29 (9th Cir. 1971); Carey v. Comm’r, 43 T.C.M. (CCH) 96 (1981); Bodley v. Comm’r, 56 T.C. 1357 (1971).


\textsuperscript{30} The concept that an expense must be “paid or incurred” in order to be deductible is a timing issue. A deduction only may be taken for the taxable year that is the proper taxable year under the method of accounting used by the taxpayer in computing its taxable income. \textit{I.R.C.} § 461(a). Under the cash method of accounting, expenses are generally deducted in the tax year they are actually paid. Treas. Reg. § 1.461-1(a)(1) (as amended in 1999). Under the accrual method of accounting, expenses are generally deductible when “all the events have occurred that establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability.” Treas. Reg. § 1.461-1(a)(2)(i).

\textsuperscript{31} \textit{I.R.C.} § 162(a).

\textsuperscript{32} 290 U.S. 111 (1933).

\textsuperscript{33} \textit{Id.} at 113-14.

\textsuperscript{34} \textit{Id.} at 113. Courts often use the “necessary” component of Section 162 to distinguish personal expenses from business expenses. In \textit{Henry v. Commissioner}, the court stated:

In determining that which is ‘necessary’ to a taxpayer’s trade or business, the taxpayer is ordinarily the best judge on the matter, and we would hesitate to substitute our own discretion for his with regard to whether an expenditure is ‘appropriate and helpful,’ in those cases in which he has decided to make the expenditure solely to serve the purposes of his business. . . . But where, as in this case, the expendi-
However, the Court was less clear on the definition of "ordinary," providing two separate meanings. First, the Court defined ordinary as normal, expected, customary or typical. The Court stated that:

Ordinary in this context does not mean that the payments must be habitual or normal in the sense that the same taxpayer will have to make them often. A lawsuit affecting the safety of a business may happen once in a lifetime. The counsel fees may be so heavy that repetition is unlikely. None the less, the expense is an ordinary one because we know from experience that payments for such a purpose, whether the amount is large or small, are the common and accepted means of defense against attack.

Second, the Court distinguished those expenses that should be immediately deductible from those that should be categorized as capital expenditures. The Court stated that:

The Commissioner of Internal Revenue resorted to that standard in assessing the petitioner's income, and found that the payments in controversy came closer to capital outlays than to ordinary and necessary expenses in the operation of a business. . . . Reputation and learning are akin to capital assets, like the good will of an old partnership. For many, they are the only tools with which to hew a pathway to success. The money spent in acquiring them is well and wisely spent. It is not an ordinary expense of the operation of a business.

Capital expenditures are denied a current deduction. Distinguishing currently deductible expenses from capital expenditures is often a difficult task. However it is necessary to make such distinction since "[t]hrough provisions such as these, the Code endeavors to match expenses with the revenues of the taxable period to which they are properly attributable, thereby resulting in a more accurate calculation of net income for tax purposes." The primary effect of characterizing a payment as either a business expense or a capital expenditure is the period over which the taxpayer recognizes income. Further, a defense against attack may well have been made to further ends which are primarily personal, this ordinary constraint does not prevail; petitioner must show affirmatively that his expenses were 'necessary' to the conduct of his professions.

36 T.C. 879, 884 (1961) (citations omitted). Personal expenses are not deductible. See I.R.C. § 262. The taxpayer has the burden of proving that an expense was incurred primarily for business, rather than personal, purposes. See Walliser v. Comm' r, 72 T.C. 433, 437 (1979); see also Boehm v. Comm' r, 35 B.T.A. 1106, 1109 (1937).

35. Welch, 290 U.S. at 113-16.
36. Id. at 113-14.
37. Id. at 114 (citation omitted); see also Deputy v. DuPont, 308 U.S. 488, 495-96 (1940) (holding that "[o]rdinary has the connotation of normal, usual, or customary. To be sure, an expense may be ordinary though it happen [sic] but once in the taxpayer's lifetime. Yet the transaction which gives rise to it must be of common or frequent occurrence in the type of business involved.")
39. Id. (citations omitted).
covers its cost. Business expenses are deductible (in full) when paid or incurred, while capital expenditures are either amortized or depreciated over their useful life or (if no useful life can be ascertained) recovered upon disposition of the asset or upon dissolution of the enterprise.

The distinction between a business expense and a capital expenditure is one "of degree and not of kind." The INDOPCO Court noted that "[a]lthough the mere presence of an incidental future benefit . . . may not warrant capitalization, a taxpayer's realization of benefits beyond the year in which the expenditure is incurred is undeniably important in determining whether the appropriate tax treatment is immediate deduction or capitalization." The Court also stated that
courts more frequently have characterized an expenditure as capital in nature because "the purpose for which the expenditure is made has to do with the corporation's operations and betterment, sometimes with a continuing capital asset, for the duration of its existence or for the indefinite future or for a time somewhat longer than the current taxable year."

In U.S. Freightways Corp. v. Commissioner, the Seventh Circuit noted that Treasury Regulations promulgated under Section 263 provided that "expenditures producing nothing more than an 'incidental' future benefit are eligible for current year deductions, while expenditures whose benefits extend 'substantially' beyond the tax year must be capitalized."

The Business Expense Deduction requires that ordinary and necessary expenses be incurred "in carrying on any trade or business." Neither the Code nor the regulations define the terms trade or business. Rather, definitions have evolved from case law. In Commissioner v. Groetzinger, the Court set forth a two-part test that is temporal and subjective. First, the taxpayer must be involved in the activity with continuity and regularity. In addition, the taxpayer's primary purpose for engaging in the activity must be for income or profit.

With respect to "carrying on" a trade or business, the taxpayer must be engaged in a trade or business to which the expenses relate at the time they are paid or incurred. This focuses, in part, on whether the taxpayer's expenses are business or personal. The taxpayer actually "carrying on" the

42. Id. at 84-85.
43. Id. at 86 (citation omitted).
44. Id. at 87.
45. Id. at 90 (citations omitted).
46. 270 F.3d 1137 (7th Cir. 2001).
47. Id. at 1141 (citing Treas. Reg. § 1.263(a)-2 (as amended in 1993)).
50. Id. at 35.
51. Id.
52. See Frank v. Comm'r, 20 T.C. 511, 513 (1953).
business appears to move some expenditures from non-deductible personal amounts to deductible business expenses. With other expenses, the fact that those expenses were incurred prior to the taxpayer carrying on a trade or business makes them capital in nature. The Service explains:

Expenses incurred in the course of a general search for or preliminary investigation of a business or investment include those expenses related to the decisions whether to enter a transaction and which transaction to enter. Such expenses are personal and are not deductible. . . . Once the taxpayer has focused on the acquisition of a specific business or investment, expenses that are related to an attempt to acquire such business or investment are capital in nature and, to the extent that the expenses are allocable to an asset the cost of which is amortizable or depreciable, may be amortized as part of the asset’s cost if the attempted acquisition is successful.53

The analysis should be similar for education expenses. The courts and the Service should look to see whether the expenditures in question are deductible business expenses, nondeductible personal expenses, or capital expenditures (which may, in certain cases, be depreciated or amortized over their useful life).54 History shows, however, that the Service and the courts generally have taken a more restrictive approach in applying Section 162 to these expenses.55

B. Historical Perspective

The question of whether education expenses qualify for the Business Expense Deduction has a long history, proceeding through four distinct stages. The first stage, beginning in 1921, was the most restrictive.56 In 1950, beginning with Hill v. Commissioner,57 courts began to relax the requirements for deductibility by allowing deductions for formal courses of instruction.58 In 1958, the Treasury Department issued the first regulations providing standards specific to education expenditures.59 These regulations were last revised in 1967.60

1. The Early Years

The Service’s initial position with respect to educational expenses was one that significantly limited their deductibility. In O.D. 892, the Service

---

54. See infra Section II.C.
55. See supra note 20 and accompanying text.
56. See infra Section II.B.1.
57. 181 F.2d 906 (4th Cir. 1950).
58. See infra Section II.B.2.
59. See infra Section II.B.3.
60. See infra Section II.B.4.
announced that "expenses incurred by school-teachers in attending summer school are in the nature of personal expenses . . . and are not deductible in computing net income." In O.D. 984, the Service stated that doctors' expenses in taking postgraduate courses were nondeductible personal expenses.

In I.T. 1520, the Service concluded that research expenses incurred by a college professor who was urged, but not required, to engage in research were nondeductible personal expenses. The research was characterized as necessary to the professor's professional recognition and standing, but it did not affect his salary. However, in G.C.M. 11654, the Service recommended that I.T. 1520 be revoked insofar as it held that the research expenses were of a personal nature. The Service concluded that such research expenditures were deductible if they were ordinary and necessary and did not constitute capital expenditures. The Service acknowledged that I.T. 1520 was inconsistent with I.T. 2602, in which the Service concluded that a member of a professional association could deduct the cost of sending a representative to the annual association convention.

In early decisions, courts also sided with the Service in holding that education expenses were personal expenditures. For example, in Appeal of Driscoll, the Board of Tax Appeals held that a taxpayer's deductions for voice lessons taken in preparation for a professional singing career were personal expenditures. In Darling v. Commissioner, the Board held that a cartoonist's expenses incurred in studying and practicing sculpture were not deductible as business expenses. See, e.g., Jack v. Comm'r, 13 B.T.A. 726 (1928), X-2 C.B. 35 (1931); Squier v. Comm'r, 13 B.T.A. 1223 (1928), X-2 C.B. 66 (1931); Coffey v. Comm'r, 21 B.T.A. 1242 (1931), X-2 C.B. 14 (1931). The Service also cited to Shutter v. Commissioner, 2 B.T.A. 23 (1925), acq., IV-2 C.B. 4, where the court allowed a minister to deduct the cost of attending a church convention essential to his standing and position, and Silverman v. Commissioner, 6 B.T.A. 1328 (1927), acq., VI-2 C.B. 6, holding that a college professor could deduct the cost of attending a professional convention as an ordinary and necessary business expense because the professor was "expected . . . to keep abreast in his particular field of work," and attendance at meetings was "expected and necessary [for this purpose and] . . . to advance the interests of the university, though his contract of employment [did] not specifically make mention of any such activities."

65. Id.
67. The Service cited to a number of cases, inconsistent with I.T. 1520, where expenses incurred by a physician in attending medical conventions were found to be deductible as business expenses. See, e.g., Jack v. Comm'r, 13 B.T.A. 726 (1928), X-2 C.B. 35 (1931); Squier v. Comm'r, 13 B.T.A. 1223 (1928), X-2 C.B. 66 (1931); Coffey v. Comm'r, 21 B.T.A. 1242 (1931), X-2 C.B. 14 (1931). The Service also cited to Shutter v. Commissioner, 2 B.T.A. 23 (1925), acq., IV-2 C.B. 4, where the court allowed a minister to deduct the cost of attending a church convention essential to his standing and position, and Silverman v. Commissioner, 6 B.T.A. 1328 (1927), acq., VI-2 C.B. 6, holding that a college professor could deduct the cost of attending a professional convention as an ordinary and necessary business expense because the professor was "expected . . . to keep abreast in his particular field of work," and attendance at meetings was "expected and necessary [for this purpose and] . . . to advance the interests of the university, though his contract of employment [did] not specifically make mention of any such activities."
68. 4 B.T.A. 1008, 1009 (1926).
deductible because his "work was purely educational and was not carried on for profit."\textsuperscript{69}

In \textit{Welch}, the Supreme Court discussed, in dicta, the rationale for not allowing a Business Expense Deduction for education expenses.\textsuperscript{70} While the Court concluded that such expenditures could be business rather than personal expenses, even in those cases, such expenses were nondeductible capital expenditures.\textsuperscript{71} Justice Cardozo stated that:

Reputation and learning are akin to capital assets, like the good will of an old partnership. For many, they are the only tools with which to hew a pathway to success. The money spent in acquiring them is well and wisely spent. It is not an ordinary expense of the operation of a business.\textsuperscript{72}

After \textit{Welch}, the Service and the courts had two distinct grounds for denying a deduction for amounts spent on education; such amounts were either personal expenses or nondeductible capital expenditures. In \textit{Osborne v. Commissioner}, the court relied on \textit{Welch} in holding that a Yale research professor could not deduct expenses for services related to the preparation and publication of scholarly and literary matter.\textsuperscript{73} The taxpayer did not expect to derive a direct or immediate profit from this work, but he hoped and expected that it would lead to advancement (possibly as a college president).\textsuperscript{74} The court stated:

Apparently his entire interest was not in current gain or present livelihood from his efforts, but in laying a foundation for the future. His position was similar to that of any student preparing and training himself for a profession or lifework; he builds a foundation of learning upon which his future living and earnings are to be based. The expenses incurred in preparing himself are in essence the cost of the capital structure from which his future income is to be derived. They are not ordinary and necessary expenses of carrying on a trade or business.\textsuperscript{75}

In 1942, the Service issued the first regulations that appeared to specifically deny a deduction for education expenses.\textsuperscript{76} Treasury Regulation 111, Section 19.23(a)-15(b) provided, in part, that "[a]mong expenditures not allowable ... are the following ... expenses of taking special courses or training."\textsuperscript{77}

\textsuperscript{69} 4 B.T.A. 499, 503 (1926), acq., VI-1 C.B. 2.
\textsuperscript{70} Welch v. Helvering, 290 U.S. 111, 115 (1933).
\textsuperscript{71} \textit{Id.} at 115-16.
\textsuperscript{72} \textit{Id.} (internal citations omitted).
\textsuperscript{73} 3 T.C. 603 (1944).
\textsuperscript{74} \textit{Id.} at 604.
\textsuperscript{75} \textit{Id.} at 605; see also Weiszmann v. Comm’r, 52 T.C. 1106, 1112 (1969), aff’d per curiam, 443 F.2d 29 (9th Cir. 1971) (discussing analysis of educational expenses in \textit{Welch} \textit{v. Helvering} in light of the 1967 Treasury Regulations).
\textsuperscript{77} \textit{Id.}
2. Between Hill and Regulatory Guidance

The Fourth Circuit’s decision in *Hill v. Commissioner* was the first to allow a Business Expense Deduction for the costs of formal instruction.\(^78\) The court concluded that, where a public school teacher was required under state law to either attend summer school or take an examination on five selected books as prerequisite for renewal of her teacher’s certificate, the costs of attending summer school were deductible as ordinary and necessary business expenses.\(^79\)

The taxpayer argued that these expenses were ordinary and necessary expenses incurred to sharpen her skills, were required by state law, and maintained—but did not improve—the status of her trade or business.\(^80\) The Tax Court denied the taxpayer’s deduction on three grounds. First, notwithstanding state regulations that permitted the summer school alternative as one permissible method of renewing the taxpayer’s teaching certificate, the court concluded that such expenses were not ordinary since the taxpayer had not shown that “the course pursued by petitioner was the usual method followed by teachers in obtaining renewals of their certificates or that it was necessary so to do.”\(^81\) Second, the Tax Court determined that the education expenses were being undertaken to obtain new employment because there was no proof that the taxpayer was employed to continue in her position at the time she attended summer school.\(^82\) Finally, the court relied on the Service’s conclusion in O.D. 892 that such expenses were “personal expenses incurred in advancing [her] education and . . . not deductible in computing net income.”\(^83\)

The Fourth Circuit reversed the Tax Court’s decision. In rejecting the Tax Court’s conclusion that such expenses were not “ordinary,” the Fourth Circuit declined to support the Tax Court’s implicit requirement for a statistical showing of which teachers chose one option for renewal of their teaching certificates over the other.\(^84\) Rather, the Fourth Circuit was satisfied that the taxpayer’s decision to attend summer school was “a response that a reasonable person would normally and naturally make under the specific circumstances.”\(^85\) The Fourth Circuit also disagreed with the Tax Court’s second conclusion—that the taxpayer failed to affirmatively prove that she was employed to continue in her position as teacher when she incurred the

---

78. 181 F.2d 906 (4th Cir. 1950), rev’g, 13 T.C. 291 (1949).
79. Id.
81. Id. at 294.
82. Id.
83. Id. at 294-95.
84. *See Hill*, 181 F.2d at 908.
85. Id.
summer school expenses. Instead, the circuit court found that “[s]he did prove to the Tax Court that she had been continuously so engaged for con-
secutive decades.” Finally, the Fourth Circuit disagreed with the lower court’s reliance on O.D. 892. However, rather than invalidating the prior precedent, the court distinguished the Service’s prior ruling by stating that such ruling was not controlling “when, as in the instant case, the attendance at summer school was undertaken essentially to enable a teacher to continue her (or his) career in her (or his) existing position.”

Following Hill, the Service issued I.T. 4044. The Service stated that it was modifying O.D. 892 to conform to the Hill decision. In I.T. 4044, the Service concluded that a teacher’s expenses for the purpose of maintaining his or her position were deductible as ordinary and necessary business expenses. However, “expenses incurred for the purpose of obtaining a teaching position, or qualifying for permanent status, a higher position, an advance in the salary schedule, or to fulfill the general cultural aspirations of the teacher, are deemed to be personal expenses which are not deductible in determining taxable net income.”

Although the court in Hill appeared to treat educational expenses in the same manner as other trade or business expenses, many courts continued to treat such expenses differently. This was especially true in connection with the requirement that such expenses be “necessary.” For example, in Welch, the Court stated that the term “necessary” should be construed to mean appropriate and helpful. However, with respect to education expenses, courts construed the term to have a more standard definition of being required.

For example, in Cardozo v. Commissioner, a professor undertook a European trip for study and research. The trip was made voluntarily, at his expense, for the purpose of increasing his prestige, to improve his reputation for scholarship and learning, and to better fit him for his current employment. The taxpayer claimed a Business Expense Deduction. The court rejected this position, concluding that such expenditures were nondeductible personal expenses. The Tax Court stated that, even assuming such expenses qualified as ordinary, they were not necessary since the taxpayer’s employer neither required nor authorized the expenditures to retain his posi-

86. Id.
87. Id. at 908-09.
88. Id. at 909.
90. Id.
91. Id.
92. Id.
93. 290 U.S. 111, 113 (1933); see supra note 34.
94. 17 T.C. 3 (1951).
95. Id. at 7.
tion. The court both distinguished Hill, and cited to the Service’s position in I.T. 4044, in reaching its conclusion.

In Coughlin v. Commissioner, the taxpayer was an attorney in general practice as a member of a firm of lawyers. The firm did considerable work that required at least one member to keep current on federal tax matters. The taxpayer maintained his tax proficiency, in part, by attending a continuing legal education tax institute. Relying on Hill, the taxpayer claimed a Business Tax Deduction. The Service argued that such expenses were nondeductible personal expenses. The Tax Court, relying on O.D. 894 and Welch, concluded that such expenditures were personal expenses, akin to capital assets, and not an ordinary expense. The Tax Court distinguished the Fourth Circuit’s decision in Hill by comparing the necessity of the expenses in the two cases. The Tax Court concluded that, whereas the taxpayer in Hill was required by state law to incur the expense, the expenses in the present case were “not deductible as ordinary and necessary business expenses because of the educational and personal nature of the object pursued by the petitioner.”

On appeal, the Second Circuit reversed the Tax Court’s finding that the only difference between the case at issue and Hill was “the degree of necessity which prompted the incurrence of the expenses.” While the taxpayer in Hill was required to take such courses to retain her position, the taxpayer in Coughlin was “morally bound” to do so. The Second Circuit also considered, and rejected, the applicability of the dicta found in Welch, stating:

The general reference to the cost of education as a personal expense [in Welch] was made by way of illustrating the point then under decision, and it related to that knowledge which is obtained for its own sake as an addition to one’s cultural background or for possible use in some work which might be started in the future. There is no indication that an exception is not to be made where the information acquired was needed for use in a lawyer’s established practice.

96. Id. at 6.
97. Id.; see also Lampkin v. Comm’r, 11 T.C.M. (CCH) 576 (1952) (holding that a college professor’s expenses in connection with his doctoral dissertation were not necessary since his program of study was not was not required to maintain his position. The court declined to decide whether such costs were nondeductible personal expenses or capital expenditures).
98. 18 T.C. 528 (1952).
99. Id.
100. Id. at 529.
101. Id.
102. Id.
103. Id. at 529-30.
104. 203 F.2d 307, 309 (2d Cir. 1953), rev’d 18 T.C. 528 (1952).
105. Id.
106. Id.
However, even after Coughlin, the Service continued to interpret the “necessary” requirement of the Business Expense Deduction differently for educational expenditures. In Revenue Ruling 55-412, the Service concluded that expenses incurred for travel and study by a teacher on sabbatical leave constituted personal expenses where such travel and study were not required in order for the teacher to maintain the teaching position.\(^{107}\) Distinguishing two of its prior pronouncements\(^{108}\) in which it concluded that similar (albeit required) expenses were deductible, the Service stated that where “the expenses of travel and study were voluntarily assumed by a teacher for the purpose of increasing his prestige, to improve his reputation for scholarship and learning, and to better fit him for the duties he was employed to perform, such expenses were considered to be personal expenses.”\(^{109}\) Accordingly, Revenue Ruling 55-412 appears to show that, at least with respect to educational expenses, the Service continued to interpret the “necessary” requirement to mean “required as a condition of employment” rather than “appropriate and helpful” as applied in other contexts.\(^{110}\)

3. The 1958 Regulations

On July 10, 1956, the Treasury Department issued its first set of comprehensive proposed regulations dealing exclusively with the deductibility of educational expenses.\(^{111}\) These regulations continued to reflect the Service’s prior position that, “[i]n general, a taxpayer’s expenditures for his education are personal and are not deductible.”\(^{112}\) However, the proposed regulations contained an exception to the general rule for expenses that satisfied a two-part test.\(^{113}\) First, the expenditures needed to be “ordinary and necessary for . . . the taxpayer’s employment or other trade or business or specialty therein” and “directly and immediately related thereto.”\(^{114}\) Second, the degree of business necessity and relationship of the expenditures were required to clearly outweigh any personal


\(^{113}\) Prop. Treas. Reg. § 1.162-5(b).

aspects of the expenses. However, any expenses that satisfied this two-part test remained nondeductible personal expenditures if they were:

[M]ade primarily for the purpose of, or . . . [had] the result of, obtaining a position for the taxpayer; qualifying him to enter an employment or otherwise become established in a trade or business or a specialty therein; establishing or enhancing substantially his reputation in his trade or business; substantially advancing him in earning capacity, salary, status, or position; or primarily fulfilling the general cultural aspirations or other personal purposes of the taxpayer.

No cases were ever decided based on the proposed regulations. On April 5, 1958, the Service finalized Treasury Regulation 1.162-5. The regulations "constituted the first systematic analysis of many of the problems inherent in the area of educational expenditures and, in general, greatly liberalized deductibility." These regulations, which contained both an

116. Prop. Treas. Reg. §§ 1.162-5(a)(2), (b). The proposed regulations provided that refresher courses were likely to qualify as deductible expenses. See Prop. Treas. Reg. § 1.162-5(c). Similarly, expenditures for education that was expressly required by an employer for the employee's "continued retention of his salary, status, or employment" were likely to qualify as a deductible expense. See Prop. Treas. Reg. § 1.162-5(d). However, where required education

in more than an incidental and relatively minor manner, . . . [had] the result of obtaining a different position for the taxpayer; qualifying him to enter an employment or otherwise become established in a trade or business or a specialty therein; establishing or enhancing substantially his reputation in his trade or business; or substantially advancing him in earning capacity, salary, status, or position[,] the expenses for such education was not deductible.

118. See Schoenfeld, supra note 20, at 255 (citations omitted). The Senate Report to the Technical Amendments Act of 1958 noted that:

The Internal Revenue Service long held that relatively few educational expenses were deductible as business expenses, or as expenses incurred in the production of income. Generally, the Service had held that for such expenses to be deductible they must be required as a condition to the retention, by the taxpayer, of his present employment. On April 4, 1958, however, the Treasury Department in a news release announced that it was issuing final regulations which were more liberal than the regulations previously in force. . . .

affirmative and a negative component, focused on the taxpayer's primary purpose for pursuing the education when determining whether the expenses qualified for a Business Expense Deduction.\textsuperscript{119}

The affirmative component provided that education expenditures would be deductible if the education was undertaken primarily to either (i) maintain or improve skills required by the taxpayer in his employment or other trade or business,\textsuperscript{120} or (ii) meet the express requirement of a taxpayer's employer, or the requirements of applicable law or regulations, imposed as a condition to the retention by the taxpayer of his salary, status or employment.\textsuperscript{121} The negative component prohibited a deduction for educational expenses undertaken primarily to either (i) obtain a new position or substantial advancement in position,\textsuperscript{122} or (ii) fulfill the general educational aspirations or other personal purposes of the taxpayer.\textsuperscript{123} Education meeting the minimum requirements for qualifying or establishing a taxpayer in her intended trade or business (or specialty therein) constituted a nondeductible personal expenditure.\textsuperscript{124}

The primary purpose approach of the 1958 regulations proved unworkable for two reasons.\textsuperscript{125} First, because different courts could reach different conclusions, "essentially identical situations could and did produce contrary results and these fact findings often turned on vague statements made by the taxpayer years before."\textsuperscript{126} Second, because the holdings in these cases revolved around factual rather than legal issues, "little or no..."
appellate review was possible; thus the coherence normally supplied by appellate review was missing. 127

4. The Current Regulations

The regulations were amended in 1967 in order to provide more specific rules with respect to the tax treatment of education expenses. 128 These regulations remain unaltered in effect today and have been upheld consistently by the courts. 129 The amended regulations have a format similar to the regulations previously finalized in 1958 by providing for an affirmative component, which must be satisfied, and a negative component, which the taxpayer cannot run afoul of. The most substantial change was the elimination of the subjective “primary purpose” test and its replacement by a more objective test. 130

The negative component of the regulations is considered first. 131 Expenditures that are determined to be “personal expenditures or [to] constitute an inseparable aggregate of personal and capital expenditures” are not deductible even if such expenditures satisfy the affirmative component of the regulations. 132

The first category of nondeductible educational expenses consists of expenses that are required by an individual “in order to meet the minimum educational requirements for qualification in his employment or other trade
or business" (the "minimum educational requirement").\textsuperscript{133} This is a question of fact that relies on a number of factors such as "the requirements of the employer, the applicable law and regulations, and the standards of the profession, trade, or business involved."\textsuperscript{134} The fact that an individual is already employed in a trade or business does not establish that he has satisfied the minimum educational requirement.\textsuperscript{135} However, once such requirement is satisfied (as when the taxpayer enters the trade or business), an individual will be treated in effect as meeting the minimum educational requirement for his trade or business even if such requirement later changes.\textsuperscript{136}

The second category of nondeductible educational expenses consists of expenses that are part of a program of study that will qualify an individual for a new trade or business (the "new trade or business test").\textsuperscript{137} This test is applied objectively, rather than subjectively. "If the education leads to qualifying the taxpayer for a new trade or business, evidence that the taxpayer never intended to enter such trade or business is irrelevant under the 1967 regulation."\textsuperscript{138} Where the taxpayer is an employee, "a change of duties does not constitute a new trade or business if the new duties involve the same general type of work as is involved in the individual's present employment."\textsuperscript{139}

Educational expenditures that do not run afoul of either the minimum educational requirement or the new trade or business test will qualify for the Business Expense Deduction if they satisfy one of the two prongs of the

\textsuperscript{133} Treas. Reg. § 1.162-5(b)(2)(i).
\textsuperscript{134} Id.
\textsuperscript{135} Id.
\textsuperscript{136} Id.; see also Treas. Reg. § 1.162-5(b)(2)(iii), ex. (1) (situation 4).
\textsuperscript{137} Treas. Reg. § 1.162-5(b)(3).
\textsuperscript{138} See Vincent G. Kalafat, Rethinking Treasury Regulation § 1.162-5 and Slaying the Monster in the Education Tax Maze, 80 NOTRE DAME L. REV. 1985, 2000-01 (2005) (citing Treas. Reg. § 1.162-5(b)(3), ex. 2). According to Kalafat, this represents the most significant change from the prior regulations. Id. (citations omitted).
\textsuperscript{139} Treas. Reg. § 1.162-5(b)(3); see also Treas. Reg. § 1.162-5(b)(3), exs. (1)-(4). The 1967 Regulation significantly liberalize the rules for deducting educational expenses with respect to education that qualifies an individual for a specialty in a particular trade or business. Compare Treas. Reg. § 1.162-5(b)(3) (1967) (disallowing a deduction where such expenditures will qualify an individual for a new trade or business) with Treas. Reg. § 1.162-5(b) (1958) (disallowing a deduction where such expenditures are required to meet the minimum requirements for qualification or establishment in an intended trade or business or specialty therein). Compare Treas. Reg. § 1.162-5(e), ex. (2) (1958) (general practitioner of medicine could not deduct courses in pediatrics because the course of study qualified him for a specialty within his trade or business) with Treas. Reg. § 1.162-5(b)(3)(ii), ex. (4) (1967) (allowing a psychiatrist to deduct the cost of a program of study and training in psychoanalysis because the study and training simply maintains or improves skills required in his trade or business and does not qualify him for a new trade or business).
affirmative component of the regulations.\textsuperscript{140} Such expenses must either (i) maintain or improve skills required by the individual in his employment or other trade or business, or (ii) meet the express requirements of the individual's employer, or of applicable law or regulations, imposed as a condition to such individual retaining "an established employment relationship, status or rate of compensation."\textsuperscript{141} With respect to the affirmative component, the wording of the current regulations mirrors that of the 1958 Regulations.

Education that maintains or improves a taxpayer's skills includes "refresher courses or courses dealing with current developments as well as academic or vocational courses" as long as such education does not also satisfy the minimum education requirement or fail the new trade or business test.\textsuperscript{142} Education imposed by an employer qualifies only if "such requirements are imposed for a bona fide business purpose of the individual's employer."\textsuperscript{143} However, only the minimum education necessary to retain an employment relationship, status, or rate of compensation may be considered.\textsuperscript{144} Additional education is only deductible if it maintains or improves the taxpayer's skills.\textsuperscript{145}

C. Critiquing the Current Regulations

The tax system classifies all expenditures to determine their proper tax treatment. The first question is whether an expenditure was made for business or personal purposes.

Business expenses—the costs incurred by the taxpayer in earning gross income—are nondiscretionary in the sense that the income is conditioned on the outlay. Personal expenditures reflect the disposition which the taxpayer elects to make out of the wealth that she has earned. Business expenses must necessarily be deductible if the income tax is to be imposed on "income"; for the same reason, personal expenditures should be disallowed.\textsuperscript{146}

\textsuperscript{140.} Treas. Reg. §§ 1.162-5(a)(1)-(2) (2011). Expenses are deductible if they satisfy the affirmative provisions of Treas. Reg. § 1.162-5(a)(1) and do not run afoul of the negative provisions of Treas. Reg. § 1.162-5(b) even if such education may lead to a degree. See Treas. Reg. § 1.162-5(a).
\textsuperscript{141.} Treas. Reg. §§ 1.162-5(a)(1)-(2).
\textsuperscript{142.} Treas. Reg. § 1.162-5(c)(1).
\textsuperscript{143.} Treas. Reg. § 1.162-5(c)(2).
\textsuperscript{144.} Id.
\textsuperscript{145.} Id.
\textsuperscript{146.} MARVIN A. CHIRELSTEIN, FEDERAL INCOME TAX 103 (11th ed. 2009). Professor Chirelstein notes that "[w]hile the line between business and personal expense is of the essence in all this, the fact is that Congress itself has chosen to cross that line fairly freely by allowing deductions for a variety of items which are plainly personal in nature" Id. at 104. Professor Oliver notes "[t]he difficulty with this assumption arises in drawing a line that is meaningful, equitable, and administrable." AMY J. OLIVER, IMPROVING THE TAX CODE TO PROVIDE MEANINGFUL AND EFFECTIVE TAX INCENTIVES FOR HIGHER EDUCATION, 12 U. FLA. J.L. & PUB.
Section 162 provides the Business Expense Deduction.\(^{147}\) Section 262 disallows a deduction—except as otherwise provided—for any “personal, living, or family expenses.”\(^{148}\) Amounts not spent “directly connected with or pertaining to” the taxpayer’s trade or business are nondeductible personal expenditures.\(^{149}\) The taxpayer has the burden of proving that an expense was incurred primarily for business, rather than personal, purposes.\(^{150}\)

There is, however, a second line-drawing exercise for business expenditures—whether such amount is a current expense or a capital expenditure. Such line drawing attempts to “match expenses with the revenues of the taxable period to which they are properly attributable, thereby resulting in a more accurate calculation of net income for tax purposes.”\(^{151}\) Only current expenses, generally those that do not create a benefit having a useful life of more than one year, are deductible in full when paid or incurred.\(^{152}\) Capital expenditures are depreciable or amortizable over their useful life, provided that a useful life can be estimated with reasonable accuracy.\(^{153}\) Accordingly, the Code sets up three categories of expenditures: (i) nondeductible personal expenditures; (ii) deductible business expenses; and (iii) capitalized business expenditures.\(^{154}\)

At first blush, the regulations applicable to education expenses appear to apply the same standard. The affirmative component of the regulations seems to be geared towards determining whether the expenses in question are business or personal expenses (i.e., whether an expense is “directly connected with or pertaining to the taxpayer’s trade or business”).\(^{155}\) The negative component of the regulations, on the other hand, appears to be geared

---

\(^{147}\) I.R.C. § 162(a) (2006). Section 212 allows a similar deduction for ordinary and necessary expenses incurred in connection with certain profit-seeking activities that do not rise to the level of a trade of business. See I.R.C. § 212(a). Section 212 is beyond the scope of this Article.

\(^{148}\) I.R.C. § 262.

\(^{149}\) Treas. Reg. § 1.162-1(a).


\(^{152}\) I.R.C. §§ 162(a), 263(a); see Treas. Reg. § 1.263(a)-2(a) (in the case of certain tangible equipment, those assets not “having a useful life substantially beyond the taxable year”); Treas. Reg. Section 1.263(a)-4(f) (in the case of intangibles, any right or benefit that does not extend beyond the earlier of 12 months after the first date that “the taxpayer realizes the right or benefit or [t]he end of the taxable year following the taxable year in which the payment is made.”); see also discussion supra notes 40-47.

\(^{153}\) See, e.g., I.R.C. §§ 167, 168, 195, 197. Where a useful life cannot reasonably be determined, the cost of such capital expenditure may be recovered when the purchased asset is later sold.

\(^{154}\) I.R.C. §§ 162(a), 262(a), 263(a).

\(^{155}\) Treas. Reg. § 1.162-1(a); see Schoenfeld, supra note 20, at 314.
towards the current expense/capital expenditure distinction (i.e., whether the expenses relate to a current or future trade or business).\textsuperscript{156} However, Treasury Regulation 1.162-5 imposes a different standard for education expenses.\textsuperscript{157} Such expenses either qualify for the Business Expense Deduction or are "personal expenditures or constitute an inseparable aggregate of personal and capital expenditures."\textsuperscript{158} No deduction is allowed for expenses in that second category under Section 262 or Section 263. There is no such thing as a business, capital expenditure for education. There is no justification for a different standard for educational expenses.\textsuperscript{159}

Application of different standards causes the regulations to be both under-inclusive and over-inclusive in the types of expenditures for which a deduction is allowed.\textsuperscript{160} Some taxpayers are denied deductions for business expenses that would have been deductible or amortizable but for the fact that such expenses relate to education. Other taxpayers are afforded a deduction, in full, for the entire cost of education even though such expenditures provide significant future benefits.

The regulations are under-inclusive in two respects—both relating to the regulation’s negative component. First, there is no basis in the law for the proposition that, where education expenditures satisfy the affirmative component of the regulations (i.e., such expenses are directly related or pertaining to the taxpayer’s current trade or business), such expenditures will be nondeductible if they also qualify the taxpayer for a new trade or business.\textsuperscript{161} In other words, a taxpayer that pursues education to maintain or improve her skills in connection with her current trade or business will be denied a deduction because she has improved herself in a manner that allows her to enter a new trade or business (even though she has no intent to do so). The regulations and case law are clear that this is an objective test, and the taxpayer’s intent is irrelevant.\textsuperscript{162} Here, the regulations treat educa-

\textsuperscript{156} Schoenfeld, supra note 20, at 315.
\textsuperscript{157} See supra note 20 and accompanying text.
\textsuperscript{158} Treas. Reg. § 1.162-5(b)(1).
\textsuperscript{159} See Schoenfeld supra note 20, at 315 (stating "[t]here is no reason to treat a business-related educational expenditure differently than any other business-related expenditure"); Katz, supra note 20, at 3 (stating "[t]here is no language in the Code, with the exception of one section [i.e., Section 274(m)(2), which disallows a deduction from expenses incurred in connection with travel as a form of education], to justify the treatment of the deductability of educational costs by a different standard"); Kalafat supra note 138, at 2002-2003.

\textsuperscript{160} The regulations have been criticized for other reasons as well. For example, one commentator concludes that the regulations are bad tax policy for failing to satisfy the principle of certainty and simplicity. Kalafat, supra note 138, at 2003-04.
\textsuperscript{161} See Schoenfeld, supra note 20, at 315.
ional expenses differently than other expenses, and exclude amounts that would be deductible in other contexts, solely because they are education expenditures.\textsuperscript{163}

The regulations are also under-inclusive because expenditures that are directly related or pertain to a new trade or business, and which meet the minimum educational requirement or otherwise qualify the taxpayer for such trade or business, should be treated as capital expenditures of such a new trade or business. These expenditures should be eligible for amortization, assuming that they have a reasonably determinable useful life. However, the regulations state that such amounts are "personal expenditures or constitute an inseparable aggregate of personal and capital expenditures."\textsuperscript{164} The regulations make this blanket statement without explaining "when or how or why educational expenditures are 'personal' or 'capital,' or when or how or why they may be 'an inseparable aggregate of personal and capital expenditures."\textsuperscript{165} This statement has only one purpose: to disallow those education expenses that relate to a new trade or business—whether or not such expenses also relate to an existing trade or business—from being amortized over their useful life as a result of the interplay between Section 262 and Section 162. In effect, it provides an implicit approval to the idea espoused by the Supreme Court in \textit{Welch} that an education expense can be a business expense, while limiting the scope of such holding by denying capitalization of these business expenses because they are also personal expenses. There is no other purpose for classifying education as a capital ex-

\textsuperscript{163} Professor Schoenfeld’s criticism that the “new trade or business” standard is not defined, and, accordingly, “any regulation based on such a vague standard is invalid” is relevant to this point. \textit{See} Schoenfeld, supra note 20, at 311. Schoenfeld concludes that any education expenses that lead to a degree will be nondeductible (notwithstanding the fact that Treas. Reg. \textsection 1.162-5(a) allows a Business Expense Deduction for expenses that qualify under the regulations “even though the education may lead to a degree”) “because that degree will almost certainly make some other position theoretically available to the taxpayer.” \textit{Id.} at 316. The new trade or business test is bad policy. According to one commentator:

When performing this seemingly speculative search to identify some new trade or business, courts generally require the education to serve only a minor role as one “helpful” step, make unlikely assumptions, and ignore important factual evidence, such as economic practicability, employer requirements, and the taxpayer’s intent.

As a result, this speculative search is a confusing and problematic approach for determining tax incentives for higher education.

\textit{Kalafat}, supra note 138, at 209. The effect of not having set standards for deductibility, and allowing each case to be decided on its facts, is that certain education only becomes deductible in certain situations, rather than being treated consistently across all taxpayers. Nowhere is this inconsistency more pronounced than in determining whether an M.B.A. degree is deductible. \textit{See}, e.g., Jill Kutzbach Sanchez, \textit{The Deductibility of MBA Degree Expenses Under Treasury Regulation 1.162-5: Are You One of the Lucky Few Who Qualify?}, 32 J. CORP. L. 659, 666-67 (2007).

\textsuperscript{164} Treas. Reg. \textsection 1.162-5(b)(1).

\textsuperscript{165} Schoenfeld, supra note 20, at 314 (citations omitted).
penditure because all nondeductible education expenses are, in part, personal expenses.166

The rationale for the presumption that all education is a "personal responsibility" providing "extensive personal rewards" stems from the earliest pronouncements by the Service167 and from cases such as Carroll v. Commissioner.168 Carroll should be limited to its facts and to undergraduate education. Whereas there might be common consensus that there is no direct and proximate relationship between a college education and the profession of being a policeman (as the court in Carroll concluded), the same does not hold true for most professional or vocational education. The rationale of the court in Carroll seems significantly weaker when one attempts to argue that a lawyer attended law school primarily for personal purposes.169

Once a direct and proximate relationship between the education at issue and the taxpayer's trade or business is shown, the expenses associated with such education should not be treated as personal expenses.170 Such amounts may be deductible if they are related to the taxpayer's current trade or business, or amortizable when related to a future trade or business. There is no reason to treat costs incurred for education differently than other costs.

The same regulations that are, at times, under-inclusive also fail, at times, by being over-inclusive. Over-inclusivity results when the regula-

166. See Treas. Reg. § 1.262-1(b)(9) (as amended in 1972) (treating Section 162 and Treas. Reg. § 1.162-5 as the exclusive means for deducting education expenses). In addition, the statutory prohibition of deducting personal expenses found in Section 262 takes precedence over the Business Expense Deduction of Section 162. See Sharon v. Comm'r, 66 T.C. 515, 522-25 (1976), aff'd, 591 F.2d 1273 (9th Cir.1978); see also I.R.C. § 261 (no deduction is allowed for any item specified in that part, including Section 262).

167. See Section II.B.1.

168. 51 T.C. 213, 215 (1968), aff'd, 418 F.2d 91 (7th Cir. 1969).

169. See Daniel I. Halperin, Business Deductions for Personal Living Expenses: A Uniform Approach to an Unresolved Problem, 122 U. PENN. L. REV. 859, 904 (1974) (where it is noted that "[t]he personal benefits at least through college seem fairly strong." However, "[i]t is hard to find any personal satisfaction in a bar review course or in a course for preparation for the CPA exam."). But see Rev. Rul. 69-292, 1969-1 C.B. 84 (expenses for a preparatory course for the CPA exam were found to be nondeductible under the current regulations).

170. See Betz v. Comm'r, 30 T.C.M. 119, 121 (1971). In Betz, the court states: Where a direct relationship between the expenditures and the trade or business of the taxpayer can be demonstrated, educational expenses are deductible. On the other hand, if the business connection is too tenuous to support a business expense deduction, or if the expenses are considered inherently personal due to the presence of overriding personal considerations, a deduction must be disallowed. Since an educational undertaking may involve a combination of business and personal motives, a determination as to the proper characterization of educational expenses, involving the joint application of sections 162 and 262, frequently becomes necessary.

Id. (citations omitted).
Tax Treatment of Higher Education Expenses

Sections allow for the current deductibility of certain education expenses that would, in other contexts, constitute capital expenditures.

For example, in *Hill*, the court allowed a deduction for university courses taken to allow the taxpayer to renew his teaching license for ten years. However, the general rule for deductibility of licenses is stated as follows:

> If an intangible asset is known from experience or other factors to be of use in the business or in the production of income for only a limited period, the length of which can be estimated with reasonable accuracy, such an intangible asset may be the subject of a depreciation allowance... An intangible asset, the useful life of which is not limited, is not subject to the allowance for depreciation.

In *Sharon v. Commissioner*, the court held that an attorney could deduct the cost of fees paid to gain admission to the California bar over his life expectancy.

In other cases, courts have allowed current deductions for graduate degrees. For example, in *Damm v. Commissioner*, the court permitted a university lecturer to deduct the costs incurred in obtaining a Ph.D. degree. The court found that the education maintained or improved his skills as a teacher without violating the minimum educational test or the new trade or business test. Noting that such expenses may provide the taxpayer with a future benefit, the court stated "Damm's education clearly may be expected to be useful in his career as [a] teacher for many years after the expenses were made. Nevertheless, neither side disputes the now-or-never status of the educational expenses deduction."

*Damm* is not the only situation in which the courts and the Service have allowed taxpayers a Business Expense Deduction for graduate degrees. Taxpayers have been allowed similar current deductions for Ph.D.,

---

172. *Richmond Hill Television Corp. v. U.S.*, 354 F.2d 410, 411-12 (4th Cir. 1965) (emphasis omitted) (holding that a radio station license was not amortizable because of its indeterminable useful life).
173. 66 T.C. 515 (1976), aff'd, 591 F.2d 1273 (9th Cir. 1978); *see also U.S. Freightways Corp. v. Comm'r*, 270 F.3d 1137 (7th Cir. 2001) (trucking company could deduct the costs of its license fees, permit fees, and insurance premiums as ordinary, necessary, and recurring expenses).
175. *Id.*
176. *Id.* at n.9 (citations omitted).
177. *See Furner v. Comm'r*, 393 F.2d 292 (7th Cir. 1968) (taxpayer, a junior high school teacher, was entitled to deduct the costs of full-time graduate study in the year such costs were incurred); *Ford v. Comm'r*, 56 T.C. 1300 (1971), aff'd, 487 F.2d 1025 (9th Cir. 1973) (per curiam) (taxpayer who received a Ph.D. in linguistics and anthropology was entitled to deduct the costs of such education in full in the year of payment).
LL.M.,\textsuperscript{178} M.B.A.,\textsuperscript{179} and advanced medical degrees.\textsuperscript{180} While over-inclusion under the current regulations is taxpayer-friendly, it violates the matching principle set forth in \textit{INDOPCO}.

To the extent that the current regulations are both under-inclusive and over-inclusive, such regulations violate fundamental principles of fairness. Some taxpayers are receiving too little benefit for their expenditures, while other taxpayers are receiving a benefit far in excess of what should be allowed. The proposal for reform, set forth in Section IV, provides a solution that attempts to properly reflect income for all taxpayers.

III. TAX INCENTIVES FOR HIGHER EDUCATION EXPENSES FOR INDIVIDUALS

In those situations where an individual’s education expenses fail to qualify for the Business Expense Deduction, such expenses may qualify for one of the Tax Incentive Provisions. As discussed in this Section, while there may be good reasons to provide incentives for higher education, the incentives currently available have not been shown to be effective tax policy, are highly complex, and may be inequitable.\textsuperscript{181}

Prior to 1997, the Code provided individuals with only a few Tax Incentive Provisions for higher education expenses.\textsuperscript{182} However, education was one of President Clinton’s top priorities.\textsuperscript{183} The Taxpayer Relief Act of 1997 represented “a significant expansion in the use of tax policy to encourage enrollment and to help families and communities pay for schools.”\textsuperscript{184} A

\textsuperscript{178} See Ruehmann v. Comm’r, 30 T.C.M. (CCH) 675 (1971) (finding a practicing lawyer was entitled to deduct the expenses incurred in obtaining an LL.M. degree); I.R.S. Priv. Ltr. Rul. 91-12-003 (Mar. 22, 1991) (same with respect to an LL.M. in taxation). But see Kohen v. Comm’r, 44 T.C.M. (CCH) 1518 (1982) (finding a taxpayer was not able to deduct an LL.M. in taxation where the taxpayer had never practiced law and was therefore not carrying on a trade or business).


\textsuperscript{180} See, e.g., Rev. Rul. 74-78, 1974-1 C.B. 44 (concluding that education that allowed a doctor to advance from general practice to a specialization in orthotics was a change in duty rather than a new trade or business).

\textsuperscript{181} See infra Section III.D.

\textsuperscript{182} These provisions included the exclusions from income for qualified scholarships, employer-provided educational assistance, student loan forgiveness, and distributions from qualified tuition plans. See infra Section III.A-C.

\textsuperscript{183} See Kane, supra note 25, at 335.

further significant expansion of these provisions occurred during the administration of President George W. Bush with the passage of the Economic Growth and Reconciliation Reform Act of 2001. The American Recovery and Reinvestment Act of 2009, enacted during President Obama's first year in office, provided an expansion of previously enacted tax incentives. Finally, The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, enacted into law in December 2010, provided an extension of many portions of the Tax Incentive Provisions.

The Tax Incentive Provisions can be best categorized by the temporal periods to which such incentives relate. The Code provides some tax benefits for current higher education expenses, incentives to save for future education expenditures, and relief for certain higher education expenses previously incurred.

A. Tax Incentives for Current Expenses—The Ghost of Christmas Present

1. Hope Scholarship Credit and Lifetime Learning Credit

Code Provision: Section 25A

Estimated Revenue Loss (Hope Scholarship Credit): 2009 - $6.7 billion, 2010 - $9.5 billion, 2011 - $4.7 billion, 2012 - $2.9 billion, 2013 - $2.9 billion

Estimated Revenue Loss (Lifetime Learning Credit): 2009 - $1.9 billion, 2010 - $2.2 billion, 2011 - $3.0 billion, 2012 - $3.2 billion, 2013 - $3.2 billion

Section 25A provides a tax credit for taxpayers who incur higher education expenses equal to the sum of the Hope Scholarship Credit plus the
Lifetime Learning Credit (hereafter, collectively, the “Education Tax Credits”).

With respect to a particular student, these two credits are mutually exclusive—i.e., a taxpayer may not claim both for the same student for the same taxable year. A taxpayer may, however, claim the Hope Scholarship Credit for one student and the Lifetime Learning Credit for another student on the same tax return. Additional rules prevent a taxpayer from claiming either credit for any expense for which a deduction is allowed under the Code.

As initially drafted, individuals could claim a nonrefundable Hope Scholarship Credit equal to one-hundred percent of the first $1,000 of qualified tuition and related expenses and fifty percent of the next $1,000 of qualified tuition and related expenses (i.e., a maximum credit of $1,500)

\[190. \text{I.R.C. } \S 25A(a) (2006), \text{enacted as part of The 1997 Taxpayer Relief Act (TRA), Pub. L. No. 105-34 (1997). The HOPE Tax credit is modeled after the Georgia State University Merit Scholarship program of the same name. HOPE is an acronym for “Helping Outstanding Pupils Educationally.” Other than the name, however, there is no relationship between the Georgia State scholarship and the federal tax credit. In fact, the state scholarship is merit-based, while the federal tax credit is income based. See The Finance of Higher Education: Theory, Research, Policy & Practice 351-52 (Michael B. Paulsen & John C. Smart, eds.) (2001).}

\[191. \text{I.R.C. } \S 25A(c)(2)(A). \]


\[193. \text{I.R.C. } \S 25A(g)(5). \text{Double benefit limitations prevent a taxpayer from claiming multiple tax incentives for the same expenses. Such limitations apply by excluding from the definition of qualifying expenses for one Tax Incentive Provision those expenses that qualify for a benefit under either another Tax Incentive Provision or provide some other benefit under the Code (i.e., a “Double Benefit”). The majority of the Tax Incentive Provisions contain some Double Benefit limitation.}

For tax years prior to 2002 and after 2012, a taxpayer is required to elect to claim the Section 25A education credits. However, during that period, no education credit is allowed for a taxable year for the qualified tuition and related expenses of a student if, during the taxable year, a distribution is made to, or on behalf of, the student from an education individual retirement account described in Section 530(b) if any portion of the distribution is excluded from gross income under Section 530(d)(2). See I.R.C. \S 25A(e), prior to amendment by the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), Pub. L. No. 107-16, § 401(g)(2)(A), 115 Stat. 38 (2001). For tax years beginning after December 31, 2001 and prior to January 1, 2013, taxpayers may elect not to have the provisions of Section 25A apply with respect to the qualified tuition and other related expenses of an individual for any taxable years. See I.R.C. \S 25A(e). The changes made to Section 25A(e) were designed to allow taxpayers to claim both a Hope Scholarship Credit and/or a Lifetime Learning Credit, on the one hand, and to exclude from income distributions made from an Coverdell ESA, on the other hand, provided that the distribution is not used for the same expenses as which the credit is claimed. The changes made pursuant to the EGTRRA were set to expire with respect to taxable years beginning after December 31, 2010. See EGTRRA, § 901. However, in December 2010, such provisions were extended for an additional two years. See Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (Tax Relief Act of 2010), Pub. L. No. 111-312, § 101(a), 124 Stat. 3296 (2010).}
paid for the first two years of an eligible student's post-secondary education in a degree or certificate program.\textsuperscript{194} These dollar amounts were indexed for inflation beginning in 2001.\textsuperscript{195} In 2008, the maximum credit was $1,800 (i.e., one-hundred percent of the first $1,200 of such expenses and fifty percent of the next $1,200 of such expenses).\textsuperscript{196} The credit has been modified temporarily for tax years 2009 through 2012\textsuperscript{197} (and renamed the American Opportunity Tax Credit) to allow for a refundable credit\textsuperscript{198} of up to $2,500 per student per year for qualified tuition and related expenses at a rate of one-hundred percent for the first $2,000 of qualified tuition and related ex-

\begin{flushright}
197. See I.R.C. § 25A(i) (added by the American Recovery and Reinvestment Act of 2009 (ARRA), Pub. L. No. 111-5, Div. B, Tit. I, § 1004(a), 123 Stat. 115, 313 (2009)). Although as initially enacted, the American Opportunity Tax Credit was set to expire after December 31, 2010, such provision has been extended for an additional two years. See Tax Relief Act of 2010, § 103(a).

In his budget for the 2011 fiscal year, President Obama proposed making the American Opportunity Tax Credit permanent. Such change is expected to increase the deficit by approximately $75 billion over the 10-year period from 2011-2020. See Office of Mgmt. & Budget, Exec. Office of the President, Budget of the United States Government, Fiscal Year 2011 (2010), available at http://www.whitehouse.gov/sites/default/files/omb/budget/fy2011/assets/budget.pdf (last visited Mar. 15, 2011). In addition, as part of his 2011 State of the Union address, President Obama pressed Congress to make such credit permanent, stating:

Of course, the education race doesn't end with a high school diploma. To compete, higher education must be within the reach of every American. That's why we've ended the unwarranted taxpayer subsidies that went to banks, and used the savings to make college affordable for millions of students. And this year, I ask Congress to go further, and make permanent our tuition tax credit—worth $10,000 for four years of college. It's the right thing to do.


The "enhanced" Hope Scholarship Credit provides that, for tax years 2008 and 2009, students attending an eligible education institution located in the Midwestern disaster area may elect a Hope Scholarship Credit equal to one hundred percent of the first $2,400 of qualified tuition and related expenses paid and fifty percent of the next $2,400 of qualified tuition and related expenses paid. In other words, the Hope Scholarship Credit for such students has been increased for such years to a maximum of $3,600. See Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, § 702, 122 Stat. 3765 (2008); see also I.R.S. Pub. 970, 20 (2009).

198. Forty percent of the otherwise allowable American Opportunity Credit is refundable. However, none of the credit is refundable if the taxpayer claiming the credit is (1) under age 18, or (2) under age 24 and a student providing less than one half his/her own support who has one living parent and does not file a joint return. Special rules apply to residents of U.S. possessions. See I.R.C. § 25A(i)(6).
penses, and twenty-five percent on the next $2,000 of qualified tuition and related expenses.199

The Lifetime Learning Credit provides individuals with a nonrefundable credit equal to twenty percent of an eligible student’s qualified tuition and related expenses paid during the taxable year.200 Unlike the Hope Scholarship Credit, which is calculated on a per-student basis, the maximum allowable Lifetime Learning Credit per year is $2,000 per taxpayer regardless of the number of students reported on the taxpayer’s return.201 Additionally, the amount of the credit is not adjusted for inflation.

For purposes of Section 25A, the term “qualified tuition and related expenses” means tuition and fees required for the enrollment or attendance of the taxpayer, the taxpayer’s spouse, or any dependent of the taxpayer at an eligible educational institution for courses of instruction of such individual at such institution.202 From 2009 through 2012, solely with respect to the American Opportunity Tax Credit, course materials (e.g., books) are

---

199. I.R.C. § 25A(i).
200. I.R.C. § 25A(c)(1). Solely for 2005 and 2006, for individuals attending an eligible educational institution in the Gulf Opportunity Zone, the credit amount was forty percent of the first $10,000 of qualified tuition and related expenses paid by the taxpayer and incurred for the taxpayer, the taxpayer’s spouse or any dependent. See I.R.C. § 14000(3) (2006) (added by the Gulf Opportunity Zone Act of 2005, Pub. L. 109-135, § 102(a), 119 Stat. 2577, 2594 (2005)). This provision was also applied to individuals who attended eligible educational institutions in Midwestern disaster areas for 2008 and 2009. See Emergency Economic Stabilization Act of 2008, §§ 702(a)(1)(B), (d)(8).
201. I.R.C. § 25A(c)(1). For taxable years beginning prior to 2003, the maximum credit was limited to $1,000. I.R.C. § 25A(c)(1). Professor Oliver notes that computing the Lifetime Learning Credit on a per-return basis rather than on a per-student basis (as is the case with the Hope Scholarship Credit) results in an inequity when the Hope Scholarship Credit is not also available in situations where a taxpayer wishes to claim tax credits for two different qualifying students. Because the Hope Scholarship Credit is available on a per-student basis, a taxpayer claiming two students eligible for the Hope Scholarship Credit can utilize the credit twice. Even where only one student is eligible for the Hope Scholarship Credit, the taxpayer could claim the Hope Scholarship Credit for one student and the Lifetime Learning Credit for the other student. However, because the Lifetime Learning Credit is available only once on a taxpayer’s return, a taxpayer claiming two students not eligible for the Hope Scholarship Credit can only take advantage of a single Lifetime Learning Credit. In addition, because the Lifetime Learning Credit is not available to married couples that file separate returns, a married couple with both spouses incurring higher education expenses receives less benefit from the credit than two single individuals. See Oliver, supra note 146, at 110-11.
202. See I.R.C. § 25A(f)(1)(A). The committee reports provide that the cost of books is not included in determining the amount of the Education Tax Credits. See H.R. Rep. No. 105-220, at 346 (1997) (Conf. Rep.). For these purposes, an “eligible educational institution” is defined as an institution which is defined in section 481 of the Higher Education Act of 1965, and which is eligible to participate in a program under title IV of such Act. See I.R.C. § 25A(f)(2). Amounts paid by the taxpayer during a taxable year for an academic period that begins during the first three months of the next year will be included in the taxable year in which the payment was made. See I.R.C. § 25A(g)(4).
included as related expenses. However, in neither case does the term “qualified tuition and related expenses” include (i) either student activity fees, athletic fees, insurance expenses; or other expenses unrelated to an individual’s academic course of instruction; or (ii) expenses with respect to any course or other education involving sports, games or hobbies, unless such course or other education is part of the individual’s degree program.

In order to prevent taxpayers from claiming a Double Benefit for the same expenses, a taxpayer must reduce her qualified tuition and related expenses by the following amounts paid for the benefit of the student: (i) qualified scholarships; (ii) educational assistance provided to present or past members of the armed forces; and (iii) any other non-taxable payment for the student’s education expenses (other than gifts, bequests, devises or inheritances).

If a student is claimed as a dependent by a parent or other taxpayer, the parent (or other taxpayer) claims the credit regardless of who pays the qualified tuition and related expenses. In addition, married couples must file a joint return for the taxable year to claim the credits.

For purposes of the Hope Scholarship Credit (including the American Opportunity Tax Credit), an “eligible student” must carry at least one-half the normal full-time load for the course of study the student is pursuing. Additionally, the credit is not allowable in any tax year for an individual unless such individual is an eligible student for at least one academic period that begins during the taxable year. Furthermore, such credit is available only for eligible students who have not been convicted of a felony offense for possession or distribution of a controlled substance. The Lifetime Learning Credit is available with respect to any course of instruction at an eligible educational institution—regardless of whether the student is enrolled full-time or part-time—to acquire or improve job skills of the student. The Lifetime Learning Credit provides no disqualification for those with drug convictions.

For tax years beginning prior to 2009 and subsequent to 2012, the Hope Scholarship Credit is available only for an eligible student’s first two years of post-secondary education. The modified American Opportunity Credit

---

205. I.R.C. § 25A(g)(2).
207. I.R.C. § 25A(g)(6).
Tax Credit is available for four years of post-secondary education. 213 The Lifetime Learning Credit applies to qualified tuition and related expenses for any course that is part of a post-secondary degree program—including graduate level education—or is taken to acquire or improve job skills. 214

The benefits of the Education Tax Credits phase out ratably for taxpayers with modified adjusted gross income in excess of certain thresholds. As initially drafted, a taxpayer must reduce the amount of the credit (but not below zero) by a fraction, the numerator of which is the excess (if any) of the taxpayer’s modified adjusted gross income over $40,000 and the denominator of which is $10,000. For individuals filing a joint return, the numerator and denominator are increased to $80,000 and $20,000, respectively. 215 For tax years beginning after 2001, the $40,000/$80,000 phase-out thresholds are adjusted for inflation. 216 For 2008, both credits were phased out for taxpayers with a modified adjusted gross income between $48,000 and $58,000 (between $96,000 and $116,000 for taxpayers filing a joint return). For 2009 and 2010, the Lifetime Learning Credit was phased out for taxpayers with a modified gross income between $50,000 and $60,000 (between $100,000 and $120,000 for taxpayers filing a joint return). 217 For 2011, the Lifetime Learning Credit phases out for taxpayers with a modified gross income between $51,000 and $61,000 (between $102,000 and $122,000 for taxpayers filing a joint return). The American Opportunity Tax Credit phases out at a higher income level (i.e., between $80,000 and $90,000 for single taxpayers, and between $160,000 and $180,000 for taxpayers filing a joint return). 218

---

213. I.R.C. § 25A(i)(2). However, any year in which the taxpayer claimed the Hope Scholarship Credit shall be counted as one of the four years for which the American Opportunity Tax Credit applies. Id.


215. I.R.C. § 25A(d). For these purposes, the term “modified adjusted gross income” is defined in I.R.C. § 25A(d)(3).


219. I.R.C. § 25A(i)(4). There is no inflation adjustment provided for the American Opportunity Tax Credit’s income limitations. Taxpayers that waive the application of the American Opportunity Tax Credit in favor of taking the Hope Scholarship Credit are required to use the lower income limitations that also apply to the Lifetime Learning Credit for those years. See supra note 197.
2. Deduction for Higher Education Expenses

Code Provision: Section 222

Estimated Revenue Loss: 2009 - $700 million, 2010 - $200 million

Congress enacted Section 222 (the “Qualified Tuition Deduction”) to provide a degree of assistance for higher income families. Section 222 was originally enacted as part of the EGTRRA as a temporary provision, effective for tax years beginning in 2002 and ending with tax years beginning on or after December 31, 2005. The history of the Qualified Tuition Deduction shows that it has always been somewhat of an afterthought—the provision was subsequently retroactively extended for two years (until December 31, 2007) by the Tax Relief and Health Care Act of 2006, re-extended retroactively (until December 31, 2009) by the Emergency Stabilization Act of 2008, with a further retroactive re-extension (until December 31, 2011) by the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010.

Section 222 provides an above-the-line deduction—i.e., the deduction is available to taxpayers regardless of whether those taxpayers itemize their deductions or avail themselves of the standard deduction—for qualified tuition and related expenses paid by the taxpayer during the taxable year. The Qualified Tuition Deduction provides a maximum deduction of $4,000 to a taxpayer with an adjusted gross income up to $65,000 (or, in the case of a joint return, $130,000). A taxpayer whose adjusted gross income exceeds $65,000 (or, in the case of a joint return, $130,000) is not eligible for the deduction.

---

227. I.R.C. § 222(b). For 2002 and 2003, the maximum deduction was limited to $3,000.
228. The definition of “adjusted gross income” is slightly different than that of “modified adjusted gross income” found in Section 25A. Compare I.R.C. § 222(b)(2)(C) with I.R.C. § 25A(d)(3).
income exceeds $65,000 but not $80,000 (or, in the case of a joint return, exceeds $130,000 but not $160,000) can deduct up to $2,000 for qualified expenses.\textsuperscript{230} Taxpayers with an adjusted gross income in excess of those limitations are not entitled to a Qualified Tuition Deduction. These income limitations are not adjusted for inflation. The income limitations for the Qualified Tuition Deduction are higher than the income limitations for the Hope Scholarship Credit or Lifetime Learning Credit (but not the American Opportunity Credit). Consequently, taxpayers whose incomes make them ineligible for those tax credits could still the avail themselves of the Qualified Tuition Deduction.

Section 222 operates in coordination with the Education Tax Credits. Section 222 shares the definition for "qualified tuition and related expenses" with those tax credit provisions.\textsuperscript{231} In addition, a Qualified Tuition Deduction may not be claimed for an individual if the taxpayer or any other person elects to claim a Hope Scholarship Credit or a Lifetime Learning Credit with respect to such individual for that year.\textsuperscript{232}

In addition to coordinating with the Education Tax Credits, the Qualified Tuition Deduction is coordinated with other Tax Incentive Provisions to prevent a double benefit for the same expenditures. Section 222 provides that the Qualified Tuition Deduction is not available for any expense for which a deduction could be claimed under any other Code provision.\textsuperscript{233} Thus, for example, a taxpayer may not avail herself of the Qualified Tuition Deduction for any expenses for which a Business Expense Deduction could be claimed. In addition, the total amount of qualified tuition and related expenses available for the deduction is reduced by the amount paid for with amounts excluded under other Tax Incentive Provisions (i.e. Section 135, Section 529 and Section 530).\textsuperscript{234}

As with the Education Tax Credits, taxpayers may claim a deduction for qualified tuition and related expenses for themselves, their spouses, or their dependents.\textsuperscript{235} The Qualified Tuition Deduction is unavailable to individuals who might have been claimed as dependents on another taxpayer's return,\textsuperscript{236} married persons filing separately,\textsuperscript{237} and nonresident aliens who do not elect to be treated as resident aliens.\textsuperscript{238}

\textsuperscript{230} I.R.C. § 222(b)(2)(B)(ii).
\textsuperscript{231} I.R.C. § 222(d)(1).
\textsuperscript{232} I.R.C. § 222(c)(2)(A); see also S. REP. NO. 107-30, at 41 (2001).
\textsuperscript{233} I.R.C. § 222(c)(1).
\textsuperscript{234} I.R.C. § 222(c)(2)(B); see also H.R. REP. NO. 107-84, at 168 (2001) (Conf. Rep.).
\textsuperscript{235} I.R.C. § 222(d)(1).
\textsuperscript{236} I.R.C. § 222(c)(3).
\textsuperscript{237} I.R.C. § 222(d)(4).
\textsuperscript{238} I.R.C. § 222(d)(5).
3. Exclusion for Scholarships and Fellowship Grants

Code Provision: Section 117

Estimated Revenue Loss: 2009 - $2.0 billion, 2010 - $2.1 billion, 2011 - $2.2 billion, 2012 - $2.3 billion, 2013 - $2.4 billion

Prior to 1954, scholarships were not specifically addressed by any section of the Internal Revenue Code, but were excludible under the general provision exempting gifts. In 1954, Congress enacted Section 117 to expand the scope of the exclusion for scholarships and in an attempt to avoid the volume of case-by-case litigation that had resulted under prior law where each grant was subjected to a "gift vs. compensation" test.

Section 117 provides that gross income does not include any amounts received as a qualified scholarship by an individual who is a candidate for a degree at an educational institution. A qualified scholarship includes any amounts received by an individual as a scholarship or fellowship grant to
the extent that the individual establishes that the amount was used for qualified tuition and related expenses.\textsuperscript{243} Section 117 is the exclusive provision excluding such amounts from gross income.\textsuperscript{244}

For these purposes, the term "qualified tuition and related expenses" includes tuition and fees required for the enrollment or attendance of a student at a qualified educational organization and fees, books, supplies and equipment required for courses of instruction at such an institution.\textsuperscript{245} Scholarship and fellowship grants that are used for other expenses, such as room and board, are not excludable from gross income.\textsuperscript{246} Section 117 does not require a tracing of funds.\textsuperscript{247} Rather, the amount of a qualified scholarship is excludable up to the aggregate amount incurred for qualified tuition and related expenses during the period covered by the grant, provided that the terms of the grant or scholarship do not earmark or designate its use for nonqualified expenses and do not specify that the funds cannot be used for tuition and course-related expenses.\textsuperscript{248}

In addition, Section 117 requires that the individual receiving the scholarship or fellowship grant be a candidate for a degree at a qualified educational organization.\textsuperscript{249} This requires the student to attend a primary or

\begin{itemize}
\item \textsuperscript{243} I.R.C. § 117(b)(1).
\item \textsuperscript{244} See Treas. Reg. § 1.117-1(a) (2011); see also Prop. Treas. Reg. § 1.117-6(b)(1).
\item \textsuperscript{245} I.R.C. § 117(b)(2). In order to be treated as related expenses, any fees, books, supplies or equipment must be required of all students in the particular course of instruction. See Prop. Treas. Reg. § 1.117-6(c)(2); see also Prop. Treas. Reg. § 1.117-6(c)(6), ex. 1.
\item \textsuperscript{246} I.R.C. § 117(b)(2). In 1986, Congress limited the exclusion to amounts for qualified tuition and related expenses and made all grants for living expenses taxable. See Tax Reform Act of 1986, Pub. L. No. 99-514, §123, 100 Stat. 2085, 2112 (1986). The stated reason for such change was that: "The Congress concluded that the exclusion for scholarships should be targeted specifically for the purpose of educational benefits, and should not encompass other items that would otherwise constitute nondeductible personal expenses." See JOINT COMM. ON TAX'N, JCS-10-87, GEN. EXPLANATION OF TAX REFORM ACT OF 1986, at 40 (1987) [hereinafter 1986 JOINT COMM. ON TAX'N REPORT].
\item \textsuperscript{247} Under the proposed regulations, taxpayers are required to keep records to establish amounts used for qualified tuition and related expenses. The regulations do not require a taxpayer to trace particular scholarship or fellowship grant amounts to particular expenditures for tuition and related expenses. See Prop. Treas. Reg. § 1.117-6(c).
\item \textsuperscript{248} H.R. REP. NO 99-841, at II-16 (1986) (Conf. Rep.).
\item \textsuperscript{249} I.R.C. § 117(a). Prior to the Tax Reform Act of 1986, the exclusion was also available to individuals who were not candidates for a degree. However, in that case, the exclusion was limited to $300 a month with a lifetime limit of 36 months. See CONG. RESEARCH SERV., S. PRT. 109-072, TAX EXPENDITURES: COMPENDIUM OF BACKGROUND MATERIAL ON INDIVIDUAL PROVISIONS 488 (Comm. Print 2006) [hereinafter TAX EXPENDITURES COMPENDIUM]. Congress determined that, in the case of grants to non-degree candidates for travel, research, and similar expenses that would be deductible as ordinary and necessary business expenses, exclusion for such expenses was not needed, and that exclusion was not appropriate if the expenses would not be deductible. See 1986 JOINT COMM. ON TAX'N REPORT, at 40. In addition, it was thought that this change to the law would lessen the number of cases flooding the courts by medical interns and residents seeking to have their
secondary school or to be an undergraduate or graduate student pursuing a degree at a college or university. The term also includes a full or part-time student at an educational institution that provides an educational program that is acceptable for full credit toward a bachelor’s or higher degree (or offers a program of training to prepare students for gainful employment in a recognized occupation) and is authorized under Federal and State law to provide such a program and is accredited by a nationally recognized accreditation agency.

Section 117 does not exclude any portion of the amount received to the extent that such amount represents payment for teaching, research or other services by the student required as a condition for receiving the scholarship. These payments are included in a recipient’s gross income in an amount determined by reference to the rate of compensation ordinarily paid for similar services performed by an individual who is not the recipient of a scholarship or a fellowship grant.

In addition to the exclusion for qualified scholarships found in Section 117(a), Section 117(d) excludes from gross income any qualified tuition reduction. A qualified tuition reduction is any reduction in tuition provided by an educational institution to an employee for the education of such

---

251. Id. at 41 (citing Zonkerman v. Comm'r, 36 T.C.M. (CCH) 6, 9 (1977) (stating that “[w]hy the amounts received by a young doctor just out of school should be treated differently from the amounts received by a young lawyer, engineer, or business school graduate has never been made clear”).
252. I.R.C. § 117(c)(1). As part of the Tax Reform Act of 1986, Congress repealed the exemption for amounts received for teaching, research or other services that are required for all degree candidates whether or not on scholarship. Scholarships received in exchange for such services are taxable to the extent of the value of all such services provided. According to the Joint Committee on Taxation, the Congress concluded, consistently with the overall objectives of the Act, that principles of fairness require that all compensation should be given the same tax treatment; that is, some individuals (e.g., students who perform teaching services for universities) should not receive more favorable tax treatment of their compensation than all other individuals who earn wages.
254. See I.R.C. § 117(d)(1).
employee or certain relatives of the employee at any qualified institution.255
The tuition reduction is exempt from gross income only if it is for education below the graduate level, with an exception for graduate students engaged in teaching or research at the institution providing the tuition reduction.256
The term does not include a reduction that represents payment for services, such as teaching or research.257

4. Exclusion for Employer-Provided Educational Assistance Programs

Code Provision: Section 127


Prior to 1978, there was no provision excluding from gross income the value of educational assistance provided by a taxpayer’s employer.259 Under prior law, the Service had ruled that where educational expenses paid on

255. See I.R.C. § 117(d)(2)(B). For these purposes, retired and disabled employees, and surviving spouses of employees are treated as employees. In addition, tuition reductions granted to a spouse or a dependent of an employee also qualifies for the exclusion. See I.R.C. § 132(h).
257. See I.R.C. § 117(c); see also Treas. Reg. § 1.117-2(a)(1). Although, at first glance, these statements (i.e., that a graduate student may qualify for a qualified tuition reduction only if he or she is engaged in teaching or research and that the amount paid for such teaching or research is taxable as gross income) appear to be confusing and, perhaps, contradictory, the following example illustrates the interplay between these concepts:

Thus, if a teaching assistant having to pay tuition of $10,000 is not required to pay any graduate school tuition at all on the condition that she teach at the institution, and the salary for similar teaching services paid to a nonstudent would be $6,000, then $6,000 would be includable salary and $4,000 would be excludable as a qualified scholarship.

259. See STAFF OF JOINT COMM. ON TAX’N, 95th CONG., GENERAL EXPLANATION OF THE REVENUE ACT OF 1978, at 124 (Comm. Print 1979) (Section 61 includes as gross income “all income from whatever source derived including, but not limited to, compensation for services”) [hereinafter GENERAL EXPLANATION REVENUE ACT OF 1978]. Although gross income excluded amounts received as scholarships or fellowship grants, the Joint Committee noted that such exclusion “is restricted to educational grants by relatively disinterested gran-
tagors who do not require any significant consideration from the recipient.” Id. (citing Bingler v. Johnson, 394 U.S. 741 (1969)).
behalf of, or reimbursed to, an employee by an employer would have qualified for the Business Expense Deduction (if paid by the employee), the payment or reimbursement was excluded from income. Where the expense would not have qualified for the Business Expense Deduction, the payment or reimbursement was includible in income. In 1978, recognizing the confusion as to when the Business Expense Deduction applied, Congress enacted Section 127.

Section 127 excludes from an employee's gross amounts paid or incurred by an employer for educational assistance to such employee pursuant to certain employer educational assistance programs ("Employer Assistance Programs" or "EAPs"). An employee may exclude a maximum of $5,250 of educational assistance furnished each year. Educational assistance

261. See GENERAL EXPLANATION REVENUE ACT OF 1978, at 125.

Because ambiguities exist in the "improve or maintain skills" test [of Treasury Regulation Section 1.162-5], the taxability of educational assistance programs of particular employers necessarily has depended on IRS agents' case-by-case analyses of the skills needed for the jobs held by each employee participating in such programs.

The "job-related" distinction often seems both ambiguous and restrictive. For example, if a person with little or no work experience is employed in an entry-level position and receives training from his employer to advance to a job requiring some greater skills or experience, the value of the training may be taxable. This may discourage self-improvement. If a typist, for example, receives training to be a secretary, or if a secretary receives training in a paralegal program, it might be considered not job-related.

GENERAL EXPLANATION REVENUE ACT OF 1978, at 126.

263. I.R.C. § 127(a)(1). In order to qualify as an EAP, the educational assistance program must meet certain requirements. First, the assistance must be provided pursuant to a separate written plan of the employer for the exclusive benefit of its employees. See I.R.C. § 127(b)(1). Second, the EAP must not discriminate in favor of highly compensated employees. See I.R.C. § 127(b)(2). Third, no more than five percent of the amounts paid or incurred by the employer during the year for educational assistance under such program may be provided to individuals that own more than five percent of such employer and their spouses and dependents. See I.R.C. § 127(b)(3). Fourth, the program must not provide eligible employees with a choice of receiving educational assistance or some other benefit that would be includible in gross income. See I.R.C. § 127(b)(4). Finally, reasonable notification of the availability and terms of the program must be available to eligible employees. See I.R.C. § 127(b)(6). There is no requirement that such program be funded. See I.R.C. § 127(b)(5).

264. I.R.C. § 127(a)(2). As originally enacted in 1978, Section 127 provided no limitation on the amount of employer-provided educational assistance excludible from gross income. See I.R.C. § 127, as enacted by the § 164 of the Revenue Act of 1978. In 1984, Section 127 was amended to provide a maximum exclusion of $5,000 per employee per calendar year. See Pub. L. 98-611, § 1, 98 Stat. 3176 (Oct. 31, 1984). The Tax Reform Act of 1986 raised the maximum amount excludable from $5,000 to $5,250. See Pub. L. 99-514, § 1162, 100 Stat. 2085 (Oct. 22, 1986). The maximum amount excludable from gross income is not adjusted annually for inflation, and today remains at the same level as in 1986.
provided to an employee in excess of the $5,250 annual limitation is excludable from gross income only if the education expenses qualify as a working condition fringe benefit.\textsuperscript{265} Accordingly, such amounts would have to be deductible by the employee (if paid by the employee) pursuant to the Business Expense Deduction.\textsuperscript{266}

Educational assistance that qualifies for the exclusion is defined as the payment by an employer of expenses incurred by or on behalf of the employee for education of the employee (including, but not limited to, tuition, fees, and similar payments, books, supplies, and equipment).\textsuperscript{267} The term also includes courses of instruction provided by the employer for the employee (including books, supplies, and equipment).\textsuperscript{268} However, educational assistance does not include: (1) tools or supplies (other than books) that may be retained by the employee after completion of a course; (2) meals, lodging, or transportation; and (3) any education involving sports, games, or hobbies.\textsuperscript{269} The exclusion for employer-provided educational assistance applies only to education provided to the employee.\textsuperscript{270} Unlike some of the other Tax Incentive Provisions, the value of educational assistance provided to an employee’s spouse or dependents is treated as compensation income.

Educational assistance provided by Section 127 includes both graduate and undergraduate courses.\textsuperscript{271} Courses do not have to be job related and can

\begin{itemize}
\item \textsuperscript{265} See I.R.C. § 132(j)(8); see also STAFF OF JOINT COMM. ON TAX’N, JCX-35-08, PRESENT LAW AND ANALYSIS RELATING TO TAX BENEFITS FOR HIGHER EDUCATION 9 (Comm. Print 2008).
\item \textsuperscript{266} I.R.C. § 132(d).
\item \textsuperscript{267} I.R.C. § 127(c)(1)(A).
\item \textsuperscript{268} I.R.C. § 127(c)(1)(B).
\item \textsuperscript{269} I.R.C. § 127(c)(1). The phrase “sports, games, or hobbies” does not include education that instructs employees how to maintain and improve health so long as such education does not involve the use of athletic facilities or equipment and is not recreational in nature. See Treas. Reg. § 1.127-2(c)(3)(iii) (2011).
\item \textsuperscript{270} I.R.C. § 127(c)(1).
\end{itemize}
help employees meet minimum requirements for current work or to prepare for a new career.\textsuperscript{272}

Section 127 was enacted as a temporary provision.\textsuperscript{273} It has been consistently extended for the past twenty-two years and was made permanent in 2001.\textsuperscript{274} However, because the changes made by EGTRRA expire, and Section 127 is not available for taxable years beginning after December 31, 2012.\textsuperscript{275}

B. Tax Incentives for Future Educational Expenses—The Ghost of Christmas Future

1. Exclusion for Earnings of Qualified Tuition Programs

Code Provision: Section 529

Estimated Revenue Loss from Prepaid Tuition Programs: 2009 - less than $50 million, 2010 - $100 million, 2011 - $100 million, 2012 - $200 million, 2013 - $100 million\textsuperscript{276}

\textsuperscript{272} CONG. RESEARCH SERV., S. PRT. 109-072, TAX EXPENDITURES: COMPRENDIUM OF BACKGROUND MATERIAL ON INDIVIDUAL PROVISIONS 491 (COMM. PRINT 2006).

\textsuperscript{273} See I.R.C. § 127, as enacted by Revenue Act of 1978, Pub. L. No. 95-600, § 164, 92 Stat. 2763, 2811 (1978), which provided that the benefits of such section would be effective for tax years beginning after December 31, 1978 and prior to January 1, 1984.


\textsuperscript{275} See EGTRRA § 901, 115 Stat. at 150, as amended by the Tax Relief Act of 2010, § 101(a).

\textsuperscript{276} See STAFF OF JOINT COMM. ON TAX’N, 111TH CONG., ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 2009-2013 39 (COMM. PRINT 2010).
Estimated Revenue Loss from College Savings Programs: 2009 - $300 million, 2010 - $400 million, 2011 - $500 million, 2012 - $700 million, 2013 - $1.0 billion

Taxpayers who wish to save for higher education expenses may do so by investing in a "Section 529" plan, aptly named for the section of the Code that governs their tax treatment. Section 529 provides that qualified tuition programs are exempt from tax. Participants in Section 529 plans contribute after-tax dollars, and distributions are exempt from taxation to the extent they are used for qualified higher education expenses.

For these purposes, the term "qualified tuition program" encompasses two different types of programs. Prepaid tuition programs allow an individual to prepay a designated beneficiary’s future tuition with today’s dollars by purchasing tuition credits or certificates on behalf of such beneficiary. These credits or certificates entitle the beneficiary to the waiver or payment of qualified higher educational expenses. College savings plans allow individuals to contribute to an account established to pay a designated beneficiary’s qualified higher education expenses at an eligible educational institution. Initially, Section 529 permitted only states to sponsor prepaid tuition programs. Changes made to Section 529 in 2001 allow such pro-

---

277. See id.
278. I.R.C. § 529, added to the Code as part of the Small Business Job Protection Act of 1996, § 1806(a), 110 Stat. at 1895.

Although prepaid tuition plans had been in existence for many years prior to 1996, one author noted “they have become particularly noteworthy in light of three recent developments.” See Eric A. Lustig, Taxation of Prepaid Tuition Plans and the 1997 Tax Provisions—Middle Class Panacea or Placebo? Continuing Problems and Variations on a Theme, 31 AKRON L. REV. 229, 232 (1997). First, in 1994, the Sixth Circuit issued a decision in Michigan v. U.S., 40 F.3d 817 (6th. Cir. 1994), holding that the annual investment income of the Michigan Education trust was exempt from tax. Id. Second, the Treasury Department issued final regulations providing that prepaid tuition plans are not debt subject to the original issue discount rules. Id. The final development related to President Clinton’s education initiatives, including the enactment of the Hope Scholarship Credit, the Lifetime Learning Credit and the educational savings account provisions of the Code. Id. at 232-33.

The Joint Committee on Taxation notes that Section 529 was enacted because “[t]he Congress believed that it is appropriate to clarify the tax treatment of State-sponsored prepaid tuition and educational savings programs in order to encourage persons to save to meet post-secondary educational expenses.” See STAFF OF JOINT COMM. ON TAX’N, 104th CONG., JCS 12-96, GENERAL EXPLANATION OF THE TAX LEGISLATION ENACTED IN THE 104TH CONGRESS 197 (Comm. Print 1996).

280. I.R.C. § 529(b)(1).
282. I.R.C. § 529(b)(1)(A)(ii). An “eligible educational institution” is defined in the same manner as such term is used for purposes of the Education Tax Credits. See supra note 202 and accompanying text.
grams also to be offered by eligible educational institutions. Only states may sponsor college savings plans.

Qualified tuition programs must meet several statutory requirements. First, the program must allow only cash purchases or contributions. Second, separate accounting must be provided for each designated beneficiary. Third, contributors and beneficiaries must be prohibited from directly or indirectly directing the investment of amounts in the program. Fourth, interests in the program (or any portion thereof) may not be used as security for a loan. Finally, adequate safeguards must be provided to prevent contributions in excess the amount necessary to provide for the beneficiary’s qualified higher education expenses.

Other than as stated above, Section 529 imposes no limitations on contributors or beneficiaries. For example, unlike some of the other Tax Incentive Provisions, there are no income caps or contribution limits imposed on contributors or beneficiaries. A contributor may establish an unlimited number of accounts for the same or for different beneficiaries. In addition,
there is no limit to the number of qualified tuition programs for which a particular person may be a beneficiary.

Section 529 provides participants and beneficiaries with a number of income, gift and estate tax benefits. With regard to income taxes, although there is no deduction for contributions to a qualified tuition program, because such programs are exempt from federal income tax, the earnings grow tax-free. In addition, the earnings and distributions generally are not includible in either the contributor’s or beneficiary’s gross income. Distributions are exempt to the extent of the amount spent by the

291. This Article generally discusses the federal income tax consequences of the Tax Incentive Provisions. However, it is worth noting that, for estate and gift tax purposes, any contribution to a qualified tuition program will be treated as a completed gift of a present interest to the designated beneficiary. See I.R.C. § 529(c)(2)(A)(i). Contributions also do not qualify as “qualified transfers” as defined in Section 2503(e). See I.R.C. § 529(c)(2)(A)(ii). Accordingly, contributions qualify for the annual gift exclusion of § 2503(b). In addition, donors have the ability to front-load their gifts by electing to take into account a contribution that exceeds her Section 2503(b) limitation ratably over a 5-year period beginning with the year of contribution. See I.R.C. § 529(c)(2)(B).

Section 529 also provides that distributions generally are not treated as taxable gifts. See I.R.C. § 529(c)(5)(A). An exception to this rule arises where the contributor changes the beneficiary or contributes the amount in a qualified tuition program to a new account for a different beneficiary. In that case, the estate and gift tax rules shall apply unless the new beneficiary is assigned to the same or a higher generation than the old beneficiary or is a member of the family of the old beneficiary (as defined in § 529(e)(2)). See I.R.C. § 529(c)(5)(B). With regard to the estate tax, Section 529(c)(4) provides that a qualified tuition program generally is not included in the gross estate of any individual. See I.R.C. § 529(c)(4)(A). There are two exceptions to the general rule. First, amounts distributed on account of the death of a beneficiary shall be includible in the gross estate of the beneficiary. See I.R.C. § 529(c)(4)(B). Second, where a donor elects to spread a single contribution out over a five-year period, and such donor dies before the close of such five-year period, the gross estate of the donor shall be required to include in his or her gross estate the portion of the contributions allocable to the periods ending after the date of death of the donor. See I.R.C. § 529(c)(4)(C).

These provisions provide for unusual results since the contributor retains the right to control the qualified tuition program (i.e., when the funds are distributed and to which beneficiary). Because of the potential for abuse, Congress empowered the Treasury Department to draft legislative regulations “necessary or appropriate to carry out the purposes of this section and to prevent abuse of such purposes.” See I.R.C. § 529(f), (added by the Pension Protection Act of 2006, Pub. L. 109-280, § 1304(b), 120 Stat. 780, 1110 (2006)).

292. This Article does not discuss the state income tax consequences of contributions to, or distributions from, a qualified tuition program. However, some states allow taxpayers that make contributions to the state’s own qualified tuition program to take a tax deduction. In addition, many states that piggyback their income tax calculations off of the federal income tax do not tax income earned by qualified tuition programs.

293. I.R.C. § 529(a).

294. I.R.C. § 529(c)(1). Prior to 2002, beneficiaries included all amounts distributed from a qualified tuition program in income. Beginning in 2002, distributions made to a beneficiary from a qualified tuition program maintained by a State (or agency or instrumen-
beneficiary on qualified higher education expenses. The portion of any excess distribution representing the earnings of the qualified tuition program is includible in the beneficiary’s gross income. In addition, the Code generally imposes a ten percent tax penalty on the amount taxable pursuant to the preceding sentence.

Section 529 defines “qualified higher education expenses” to include tuition, fees, books, supplies and equipment required for the enrollment or attendance of a designated beneficiary at an eligible education institution.

Originally, these amendments to Section 529 were due to expire after December 31, 2010. See EGTRRA § 901. However, the Pension Protection Act of 2006 made such amendments permanent. See Pension Protection Act, Pub. L. 109-280, § 1304(a), 120 Stat. 780, 1110 (2006).

I.R.C. §§ 529(c)(3)(A), (B). Section 529(c)(3) uses the annuity rules of Section 72 to determine the amount of the distribution includible in income. These rules divide the distribution into two components representing the contributions to and the earnings of the qualified tuition program. Only the earnings are potentially subject to tax, and then only proportionately based on the ratio that the amount not spent on qualified higher education expenses bears to the amount of the distribution. The following example illustrates this point:

Assume that A is the beneficiary of a qualified tuition plan. The plan has a total balance of $50,000 (consisting of $20,000 of contributions and $30,000 of earnings). During the year, A withdraws $15,000 from the account.

In this example, 40 percent of the distribution represents a return of capital (i.e., $20,000/$50,000 * $15,000 = $6,000) that will never be includible in beneficiary’s gross income and 60 percent of the distribution ($30,000/$50,000 * $15,000 = $9,000) represents accumulated earnings (which may be included or excluded from income depending on the beneficiary’s qualified education expenses for the year).

If the beneficiary’s qualified education expenses equal or exceed $15,000, no portion of the distribution will be includible in gross income. If, however, the beneficiary incurs less than $15,000 of qualified education expenses, only the portion of the $9,000 of accumulated earnings that bears the same ratio as the qualified education expenses incurred bears to the aggregate distributions is excluded from income. Thus, if the beneficiary’s qualified education expenses for the year totaled $12,000, since $12,000 is 80 percent of the amount of the total distribution, only 80 percent of the amount of the distribution that constitutes accumulated earnings (i.e., 80 percent of $9,000 = $7,200) is excluded from gross income. Accordingly, $1,800 ($9,000 - $7,200) is included in the beneficiary’s income.

See I.R.C. § 529(c)(6), which incorporates the provisions of Section 530(d)(4). Thus, in addition to paying income tax on $1,800 of gross income, the beneficiary in the example in the preceding footnote would be subject to an additional tax of $180.

I.R.C. § 529(e)(3)(A)(i). Solely for 2009 and 2010, such term included expenses for the purchase of any computer technology or equipment, or internet access or related services, if such technology, equipment or services are to be used by the beneficiary and the beneficiary’s family for any of the years that the beneficiary is enrolled at an eligible education institution. See I.R.C. § 529(e)(3)(A)(iii).
Such term also includes reasonable costs incurred by the designated beneficiary for room and board for students who are generally carrying at least one-half of the normal full-time workload for the course of study that such student is pursuing.299 Finally, the term also includes expenses for special needs services (in the case of a special needs beneficiary) that are incurred in connection with such enrollment or attendance.300

In order to prevent a Double Benefit, the amount of qualified higher education expenses is reduced by the tax-free amount of any scholarship received by the beneficiary, any other payments received by such beneficiary that are excluded from gross income (other than gifts, bequests and inheritances), as well as by the amount of such expenses claimed by any taxpayer (with respect to the beneficiary) in determining the amount of the Hope Scholarship Credit or the Lifetime Learning Credit.301 Finally, since 2002, an individual can be a beneficiary of both a qualified tuition program and a Coverdell Education Savings Account.302 To the extent that the distributions received by a beneficiary under both provisions exceeds the beneficiary’s qualified higher education expenses, such expenses must be allocated among the distributions to determine the amount of income includible under each provision.303

2. Exclusion for Earnings from Education Savings Accounts

Code Provision: Section 530

Estimated Revenue Loss from Prepaid Tuition Programs:
2009 - $100 million, 2010 - $100 million, 2011 - $100 million, 2012 - $200 million, 2013 - $200 million304

Enacted in 1997,305 and liberalized in 2001,306 Section 530 provides taxpayers with another tax-favored savings plan. These plans, originally

---

299. I.R.C. § 529(c)(3)(B)(i), which incorporates the definition of an “eligible student” from Section 25A(b)(3). The amount of room and board treated as a qualified higher education expense is limited to the greater of (i) the allowance (applicable to the student) for room and board included in the cost of attendance as determined by the eligible educational institution for such period, and (ii) the actual invoice amount the student residing in housing owned or operated by the eligible educational institution is charged by the institution for room and board costs during such period. See I.R.C. § 529(c)(3)(B)(i).
301. I.R.C. § 529(c)(3)(v).
referred to as Education Individual Retirement Accounts, were renamed in
2001, and are now known as Coverdell Education Savings Accounts (here-
after “Coverdell ESAs”).

A Coverdell ESA is a trust created or organized in the United States
exclusively for the purpose of paying qualified education expenses of des-
ignated beneficiaries (who must be individuals) that is so designated at the
time of its creation or organization. In addition, the written governing
instrument creating the trust must provide that: (i) contributions must be
limited to cash, made before the beneficiary turns eighteen, and not result in
aggregate contributions for the year in excess of $2,000; (ii) the trustee is
either a bank or another fiduciary that demonstrates to the satisfaction of the
Secretary that the trust will be administered consistent with the require-
ments of Section 530 (or who has so demonstrated with respect to any indi-
vidual retirement account); (iii) no part of the trust’s assets will be in-
vested in life insurance contracts; (iv) the assets of the trust will not be
commingled with other property (except in a common trust fund or invest-
ment fund); and (iv) except in certain situations, any balance credited to a
designated beneficiary must be distributed to such beneficiary within 30
days after such beneficiary attains the age of thirty.

Coverdell ESAs function similarly to Section 529 qualified tuition
plans. Contributions made to a Coverdell ESA are not deductible. Howev-
er, because a Coverdell ESA is exempt from tax, earnings on amounts in
Coverdell ESAs are not taxable prior to distribution. Distributions are not
includible in a beneficiary’s gross income to the extent of the amount spent
by the beneficiary on qualified higher education expenses. The portion of
any excess distribution representing the Coverdell ESA’s earnings is includ-
able in the beneficiary’s gross income. In addition, the Code imposes a
ten percent tax penalty on the amount taxable pursuant to the preceding sentence.\textsuperscript{317}

One difference between the two sections is that, while Section 529 provides tax-favored treatment to distributions only when the amounts distributed are used to pay for qualified higher education expenses, distributions from a Coverdell ESA can be used for qualified higher education expenses and qualified elementary and secondary education expenses.\textsuperscript{318} However, with respect to higher education expenses, the two provisions overlap in that both use the same definition for “qualified higher education expenses.”\textsuperscript{319} Where a beneficiary receives distributions from both a Coverdell ESA and a qualified tuition plan, the Code contains rules to coordinate the amount, if any, includible in the beneficiary’s income.\textsuperscript{320}

The law initially allowed for a maximum contribution of $500.\textsuperscript{321} The contribution limit was increased to $2,000, effective for tax years 2002 through 2012.\textsuperscript{322} Beginning on January 1, 2013, the maximum annual contribution will revert back to $500.\textsuperscript{323} The contribution limit applies on an aggregate basis both at the contributor and beneficiary level.\textsuperscript{324} The $2,000 contribution amount is reduced, but only if the contributor is an individual, by $1 for each $15 (or $1 for each $30, in the case of a joint return) by which the contributor’s modified adjusted gross income exceeds $95,000 (or $190,000, in the case of a joint return).\textsuperscript{325} Accordingly, no contributions

\textsuperscript{317}. I.R.C. § 530(d)(4).
\textsuperscript{318}. I.R.C. § 530(b)(2). The amendments to Section 530(b)(2), which expanded the definition of qualified education expenses to include qualified elementary and secondary education expenses, expire after December 31, 2012. See EGTRRA, Pub. L. No. 107-16, § 901(a), 115 Stat. 38 (2001) (as amended by the Tax Relief Act of 2010, Pub. L. No. 111-312, § 101(a), 124 Stat. 3296 (2010)). Accordingly, after such date, the expenses covered by Section 529 plans and Coverdell ESAs will be identical.
\textsuperscript{319}. I.R.C. § 530(b)(2)(A)(i). Section 530 provides the same rules found in Section 529 to prevent a Double Benefit. See I.R.C. § 530(d)(2)(C)(i); I.R.C. § 529(c)(3)(v).
\textsuperscript{320}. See I.R.C. § 530(d)(2)(C)(ii); I.R.C. § 529(c)(3)(vi).
\textsuperscript{322}. EGTRRA § 401(a).
\textsuperscript{323}. EGTRRA § 901(a) (as amended by the Tax Relief Act of 2010 § 101(a)).
\textsuperscript{324}. I.R.C. §§ 530(b)(1)(A)(iii), 4973(e)(1). Excess contributions generally are subject to a six percent excise tax. See I.R.C. § 4973(a)(4); I.R.S. Notice 97-60, 1997-2 C.B. 310, § 3, Q&As 5, 12 (although more than one Coverdell ESA may be created for the benefit of a particular child, the $2,000 ceiling applies to all contributions by all contributors for such child’s benefit); see also I.R.S. Pub. 970, 41 (2011). The $2,000 maximum contribution limitation does not apply to any rollover contributions. See I.R.C. §§ 530(b)(1)(A)(iii), 4973(e)(2).
\textsuperscript{325}. I.R.C. § 530(c)(1). “Modified gross income” is defined in I.R.C. § 530(c)(2). Interestingly, “corporations and other entities (including tax-exempt organizations) are permitted to make contributions to [Coverdell ESAs], regardless of the income of the corporation or entity during the year of the contribution.” See H.R. REP. No. 107-84, at 151 (Conf. Rep. 2001). The exception to the income limitation rules for corporations and other entities
may be made if the modified adjusted gross income of an individual contributor exceeds $110,000 (or $220,000 in the case of a joint return).326

3. Exclusion for Interest on United States Savings Bonds

Code Provision: Section 135

Estimated Revenue Loss: Less than $50 million each year from 2009 through 2013327

Section 135 was among the first Tax Incentive Provisions available to assist in saving for postsecondary education.328 However, as a result of statutory limitations, this incentive is not as attractive an investment as some other education savings vehicles.329

Section 135 excludes from income interest received by certain taxpayers on the redemption of qualified United States savings bonds when the taxpayer pays qualified higher education expenses during the year.330 If the taxpayer’s qualified higher education expenses exceed the amount of the bonds redeemed, all of such interest is excluded.331 Where the redemption proceeds exceed the amount of qualified higher education expenses, the interest is includible in income in the same manner as excess distributions from a qualified tuition plan or a Coverdell ESA.332

is eliminated after December 31, 2012. See EGTRRA § 901(a) (as amended by the Tax Relief Act of 2010 § 101(a)).

326. Beginning in 2013, the $500 contribution amount will be reduced, regardless of whether the contributor is an individual or an entity, by $1 for each $15 (or, $1 for each $10, in the case of a joint return) by which the contributor’s modified adjusted gross income exceeds $95,000 (or $150,000, in the case of a joint return). Accordingly, no contributions may be made if the modified adjusted gross income of an individual or entity making the contribution exceeds $110,000 (or $160,000, in the case of individuals filing a joint return). See I.R.C. § 530(c)(1) (prior to amendment by 2001 EGTRRA § 401(b)).


329. Id. at 589.


331. I.R.C. § 135(a).

332. I.R.C. § 135(b)(1); see also supra notes 296, 316. The following example illustrates this point:

In February 2009, Mark and Joan Washington, a married couple, cashed a qualified series EE U.S. savings bond. They received proceeds of $9,000, representing principal of $6,000 and interest of $3,000. In 2009, they paid $7,650 of their daughter’s college tuition. They are not claiming the American opportunity, Hope, or lifetime learning credit for those expenses, and their daughter does not have any tax-free educational assistance. Their MAGI for 2009 was $80,000.
A "qualified United States savings bond" is defined as a United States savings bond issued at a discount after December 31, 1989 to an individual who was at least 24 years old as of the date of issuance. The United States savings bonds that qualify for this exclusion are Series EE or Series I Savings Bonds. The exclusion is not available to an individual who owns bonds that such individual or his spouse did not purchase.

"Qualified higher education expenses" include only tuition and fees required for enrollment or attendance of the taxpayer, the taxpayer's spouse, or any dependent of the taxpayer at an eligible education institution. Expenditures for courses in sports, games, or hobbies are not considered unless they are part of a degree program. Amounts contributed to a qualified tuition program or a Coverdell ESA for which the taxpayer, the taxpayer's spouse or a dependent of the taxpayer is a designated beneficiary shall be treated as a qualified higher education expense for these purposes. Married couples are required to file a joint return to utilize the exclusion.

Section 135 denies a Double Benefit for education expenses by reducing the amount of qualified higher education expenses of an individual by

\[
\text{\$3,000 interest} \times (\frac{\$7,650 \text{ AQEE}}{\$9,000 \text{ proceeds}}) = \text{\$2,550 tax-free interest}
\]

They can exclude \$2,550 of interest in 2009. They must pay tax on the remaining \$450 (\$3,000 - \$2,550) interest.


333. I.R.C. § 135(c)(1).

334. See I.R.S. Pub. 970, at 73; see also CONG. RESEARCH SERV., S. PRT. 109-072, TAX EXPENDITURES: COMPENDIUM OF BACKGROUND MATERIAL ON INDIVIDUAL PROVISIONS 475 (Comm. Print 2006). "Series EE Bonds are accrued bonds which earn a variable interest rate equal to 90 percent of the average yield on 5-year Treasury securities for the preceding six months. Series I Bonds are accrued bonds that earn a fixed rate of return plus a variable semi-annual inflation rate." Id.

335. See Technical Miscellaneous Revenue Act of 1988, H.R. REP. NO. 100-1104, at 141 (2d Sess. 1988) (Conf. Rep. to accompany H.R. 4333). This puts significant limitations on the ability to use Section 135 to save for higher education. The Conference Report accompanying the law enacting Section 135 provides that:

The exclusion is not available to an individual who is the owner of a Series EE bond which were purchased by another individual, other than a spouse. Under this rule, interest on bonds purchased by an individual to be redeemed in (say) 10 years when a dependent of the individual attends a college is eligible for the exclusion. However, the exclusion will not be allowable if bonds are purchased by a parent and put in the name of the child or another dependent of the taxpayer, or if bonds are purchased by an individual who is under age 24 at the time of purchase.

Id.

336. I.R.C. § 135(c)(2)(A). For these purposes, the term "eligible education institution" has the same meaning as provided in §529(e)(5). See also I.R.C. § 135(c)(3).


338. I.R.C. § 135(c)(2)(C). However, in order to prevent a Double Benefit, such contribution shall not be treated as a contribution under Section 529 and Section 530 in determining the portion of the distribution that represents a return of investment.

any scholarships, veterans’ education assistance, employer education assistance or similar assistance received by such individual. The amount of qualified higher education expenses is further reduced by excluding expenses that are used in the computation of the Education Tax Credits or to compute the amount excluded from a distribution from a qualified tuition program or a Coverdell ESA.

The benefit provided by Section 135 is phased out for middle- and upper-income taxpayers. As introduced in 1988, the interest exclusion was reduced proportionately based on the ratio that the taxpayer’s modified adjusted gross income in excess of $40,000 (or $60,000, in the case of a joint return) bore to $15,000 (or $30,000, in the case of a joint return). However, for taxable years beginning after 1990, the $40,000 and $60,000 amount have been indexed for inflation. For 2010, the exclusion under Section 135 begins to phase out for a taxpayer having a modified adjusted gross income above $70,100 ($105,100 for joint returns), and is completely phased out for a taxpayer having a modified adjusted gross income at or above $85,100 ($135,100 for joint returns).

For 2011, the exclusion under Section 135 begins to phase out for a taxpayer having a modified adjusted gross income above $71,100 ($106,650 for joint returns) and is completely phased out for a taxpayer having a modified adjusted gross income at or above $86,100 ($136,650 for joint returns). These income limitations, unlike those limitations applicable to Coverdell ESAs (which apply to contributions rather than distributions), apply at the time the bonds are redeemed (rather than at the time of purchase). Accordingly, families intending to purchase savings bonds as a means to save for college expenses must predict their income eligibility far in advance.

4. Relief from Penalties for Withdrawals from IRAs

Code Provisions: Section 408 and Section 408A

343. See I.R.C. § 135(b)(2)(A) (as enacted by Technical and Miscellaneous Revenue Act of 1988, Pub.L. 100-647, § 6009(a)).
344. See I.R.C. § 135(b)(2)(B) (as enacted by the 1988 TAMRA § 6009(a)).
347. Because these relief provisions are not considered tax expenditures, the federal government does not provide revenue loss estimates.
As a general rule, if a taxpayer makes a withdrawal from his individual retirement account ("IRA") before reaching the age of 59 1/2, in addition to paying federal income taxes on the amount withdrawn (except to the extent the withdrawal is a return of nondeductible contributions), the taxpayer also must pay a ten percent penalty tax on all or part of the amount withdrawn. However, since January 1, 1998, a taxpayer making a withdrawal from an IRA to pay his "qualified higher education expenses" will be required to pay the federal income tax on the withdrawal, but will not be subject to the additional tax of ten percent. The exception to this additional tax applies only to the extent that the amount of the distribution does not exceed the qualified higher education expenses during the taxable year for the taxpayer, the taxpayer's spouse, or any child or grandchild of the taxpayer or the taxpayer's spouse at an eligible educational institution.

Qualified distributions from a Roth IRA generally are not includible in gross income. A qualified distribution is any distribution that is made after the five-taxable year period beginning with the first taxable year for which the individual made a contribution to the Roth IRA, and after either

---

348. See I.R.C. § 408(d) (regarding the taxability of distributions from an IRA.); see also I.R.C. § 72(t)(1) (regarding the general rules providing for a 10 percent penalty on early withdrawals).


The Congress believed that it is both appropriate and important to allow individuals to withdraw amounts from their IRAs for purposes of paying higher education expenses without incurring an additional 10-percent early withdrawal tax.

The Act provides that the 10-percent early withdrawal tax does not apply to distributions from IRAs (including new Roth IRAs created by the Act) if the taxpayer uses the amounts to pay qualified higher education expenses (including those related to graduate-level courses) of the taxpayer, the taxpayer's spouse, or any child, or grandchild of the taxpayer or the taxpayer's spouse.


350. See I.R.C. §§ 72(t)(2)(E), 72(t)(7)(A); see also I.R.S. Notice 97-60, 1997-2 C.B. 310 (Nov. 17, 1997). For these purposes, the Code defers to Section 529 for purposes of defining "qualified higher education expenses." See I.R.C. § 72(t)(7)(A). Qualified higher education expenses paid with an individual's earnings, the proceeds of a loan, a gift, an inheritance given to the student or the individual making the withdrawal, or personal savings (including savings from a Section 529 qualified tuition program) are included in determining the amount of the IRA withdrawal which is not subject to the 10 percent early withdrawal tax. See I.R.S. Pub. 970, 71 (2009). However, qualified higher education expenses paid with a Pell Grant, a scholarship excluded from income under Section 117, a distribution from a Coverdell ESA not includible in income under Section 530, employer-provided educational assistance excluded from gross income under Section 127, or any other nontaxable payment (other than gifts and inheritances) are excluded in computing the amount of a taxpayer's qualified higher educational expenses for these purposes. Id. at 72.

351. I.R.C. § 408A(d)(1).
(i) attainment of age 59-1/2; (ii) on account of death or disability; or (iii) which is a “qualified special purpose distribution” (within the meaning of Section 408A(d)(5)).\textsuperscript{352} Distributions from a Roth IRA that are not qualified distributions are includible in income to the extent attributable to earnings (i.e., distributions are not taxable to the extent such amount represent a return of contributions).\textsuperscript{353} In addition, distributions other than qualified distributions are subject to the same ten percent penalty as traditional IRAs on amounts that are includible in income.\textsuperscript{354} The rules that exempt traditional IRA distributions from the ten percent early withdrawal penalty similarly apply to nonqualified distributions from a Roth IRA.\textsuperscript{355}

C. Tax Incentives for Prior Educational Expenses—The Ghost of Christmas Past

1. Deduction for Interest on Qualified Education Loans

Code Provision: Section 221


The Code generally provides no deduction for personal interest paid or incurred by individuals.\textsuperscript{357} Personal interest is defined as all interest other than six specifically enumerated types of interest, including interest on indebtedness properly allocable to the taxpayer’s trade or business and interest on a qualified education loan.\textsuperscript{358} Where an individual’s debt was incurred to pay for higher education expenses, three possible outcomes may occur. First, the interest may qualify for a Business Expense Deduction. Second, the interest may be deductible under Section 221, if the loan is a qualified education loan. Finally, the interest may be treated as nondeductible personal interest.

Whether interest qualifies for a Business Expense Deduction depends on whether the cost of the underlying education would qualify for a Business Expense Deduction under Section 162 and Treasury Regulation Sec-

\textsuperscript{352} I.R.C. § 408A(d)(2).
\textsuperscript{353} I.R.C. §§ 408A(a); 408(d)(1).
\textsuperscript{354} I.R.C. §§ 408A(a); 72(l)(1).
\textsuperscript{355} I.R.C. §§ 408A(a); 72(l)(2)(E); see supra note 349.
\textsuperscript{356} See STAFF OF JOINT COMM. ON TAX’N, 111th CONG., ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 2009-2013 38 (Comm. Print 2010).
\textsuperscript{358} I.R.C. §§ 163(h)(2)(A), (F); 221(a).
In Holmes v. Commissioner, the Tax Court concluded that, where a taxpayer incurred loans "to further education in order to obtain a new trade or business," the interest on such loans was not deductible.360

Interest that does not qualify for a Business Expense Deduction may still be deductible under Section 221.361 Designed to ease the financial burden imposed on taxpayers as a result of considerable borrowings to finance their undergraduate and graduate educations,362 Section 221 allows a deduction for up to $2,500 of interest paid on a qualified education loan.363 The amount of the deduction is not indexed for inflation. The deduction is an above-the-line deduction, meaning that it is available to taxpayers who both itemize and take the standard deduction.365 The student loan interest deduction is available only for interest paid by the taxpayer.366 The deduction is not available to married taxpayers who file separate returns or to persons that may be claimed as a dependent on another's tax return.368

359. See supra Part II.
360. 66 T.C.M. (CCH) 516 (1993); see also Mullin v. Comm'r, 81 T.C.M. (CCH) 1655, 1656 (2001) (concluding that "[t]he deductibility as a business expense of interest on a loan obtained for educational expenses depends, at least in part, upon whether the educational expenses themselves are deductible business expenses").
361. For purposes of Section 221, interest includes both qualified stated interest and original issue discount (including capitalized interest, loan origination fees, and late fees). See Treas. Reg. § 1.221-1(f)(1) (2011).
363. See I.R.C. § 221(b)(1). The maximum deduction allowed in 1998 was $1,000. I.R.C. § 221(b)(1). This amount was increased to $1,500 in 1999, $2,000 in 2000 and $2,500 in taxable years beginning in 2001 or thereafter. I.R.C. § 221(b)(1).
364. See I.R.C. §§ 221(a), 221(b)(1). As initially enacted, Section 221(d) provided that a deduction was allowed "only with respect to interest paid on any qualified education loan during the first 60 months (whether or not consecutive) in which interest payments are required." 1997 TRA, Pub. L. No. 105-34, § 202(a), 111 Stat. 788, 806-07 (1997). Regulations promulgated under Section 221 set forth rules determining when such 60-month period begins and ends, as well as when such period could be suspended. See Treas. Reg. § 1.221-2(e)(3) (2011).
365. Section 221(d) was eliminated in 2001, providing for interest on a qualified education loan to be deductible throughout the entire life of the loan. See EGTRRA, Pub. L. No. 107-16, §§ 402(b)(2)(B), 412(a)(1), 412(b)(1), 412(2), 431(c)(2), 115 Stat. 38, 61, 63, 64, 68. (2001). The amendments made to Section 221 by EGTRRA are set to sunset after December 31, 2012 and, absent Congressional action, the 60-month rule will be effective for taxable years beginning after December 31, 2012. See EGTRRA § 901(a) (as amended by the Tax Relief Act of 2010, Pub. L. No. 111-312, § 101(a), 124 Stat. 3296, 3298 (2010)).
367. I.R.C. § 221(a). The regulations provide that the taxpayer must be legally obligated to make interest payments under the terms of the loan. See Treas. Reg. § 1.221-1(b)(1).
368.Treas. Reg. § 1.221-1(b)(3). Although a dependent student cannot deduct the loan interest, his or her parents can qualify for the deduction by taking out the loan in their own names (and thus becoming legally liable on the debt) since a qualified education loan in-
As initially enacted, the maximum annual deduction was phased out ratably for single taxpayers with a modified adjusted gross income between $40,000 and $55,000, and married taxpayers filing a joint return with a modified gross income between $60,000 and $75,000. Inflation adjustments were created to take effect after 2001. In 2001, Section 221 was amended both to raise the income limitation and to repeal the effects of the marriage penalty. Thus, effective for the 2002 tax year, the maximum annual deduction was phased out ratably for single taxpayers having a modified adjusted gross income between $50,000 and $65,000, and for married taxpayers filing a joint return with modified adjusted gross income between $100,000 and $130,000. For both 2010 and 2011, the maximum annual deduction is phased out ratably for single taxpayers with modified adjusted gross income between $60,000 and $75,000, and for married taxpayers filing a joint return with modified adjusted gross income between $120,000 and $150,000.

For purposes of Section 221, a “qualified education loan” is defined as any indebtedness incurred by the taxpayer solely to pay qualified higher education expenses incurred on behalf of the taxpayer, the taxpayer’s spouse or any dependent of the taxpayer as of the time the debt was incurred. Such expenses must be paid or incurred within a reasonable time.
before or after the indebtedness was incurred.\textsuperscript{375} Finally, the expenses must be ones that are attributable to education furnished during a period in which the recipient was an eligible student.\textsuperscript{376} Interest paid on mixed-use loans is not deductible.\textsuperscript{377} Indebtedness used solely to refinance a qualified education loan also constitutes a qualified education loan.\textsuperscript{378} If, however, a taxpayer refinances a qualified education loan for more than the balance of the original loan, any excess must be solely used to pay qualified education expenses (and the loan must satisfy the other requirements of a qualified education loan) or none of the interest paid on the loan is deductible.\textsuperscript{379}

Section 221 defines “qualified higher education expenses” to mean the cost of attendance at an eligible education institution\textsuperscript{380} as defined in Section 472 of the Higher Education Act of 1965, as in effect on August 4, 1997 (the date of enactment of the Taxpayer Relief Act of 1997).\textsuperscript{381} Such expenses include “tuition and fees normally assessed [to] a student carrying the same . . . workload as the student, an allowance for room and board, and an allowance for books, supplies, transportation, and miscellaneous expenses of the student.”\textsuperscript{382} To prevent a Double Benefit, the amount of qualified higher education expenses does not include the amount of any such expenses paid with the proceeds of: (i) tax-free scholarships; (ii) educational assistance provided to present or past members of the armed forces; (iii) tax-free amounts received under an EAP; (iv) any other non-taxable payment for the student’s education expenses (other than gifts, bequests, devis-
es or inheritances); (v) amounts constituting interest received tax-free upon the redemption of United States savings bonds; and (vi) tax-free distributions received from a qualified tuition plan or Coverdell ESA. No Double Benefit rule prevents a taxpayer who borrows money for expenses, and takes an Education Tax Credit with respect to such expenses, from deducting the interest paid on the loan.

Section 221(e)(1) also denies a deduction to the extent that another Code provision allows a deduction. Thus, a taxpayer that incurs a home equity loan that qualifies as deductible home mortgage interest under Section 163(h)(3), and uses the proceeds to pay for qualified education expenses, cannot deduct the interest under Section 221 even though the above-the-line deduction for student loan interest may provide a greater benefit than the itemized deduction for home equity interest.

2. Exclusion for Student Loan Forgiveness

Code Provision: Section 108(f)

Estimated Revenue Loss: $100 million for each tax year from 2009 through 2013

Taxpayers generally include any discharge of indebtedness in gross income. However, to encourage students to work in underrepresented professions and areas, student loans are sometimes granted under programs that forgive all or a portion of the loans when borrowers agree to and actually perform services in those designated professions and areas.

Congress enacted Section 108(f) to encourage certain trained professionals to serve in rural and low-income neighborhoods. Since recipients

383. I.R.C. § 221(d)(2); see also Treas. Reg. § 1.221-1(e)(2)(ii).
384. See Treas. Reg. § 1.221-1(g)(2).
387. While not part of his tax proposals, President Obama showed support for loan forgiveness programs as part of his 2010 State of the Union address when he stated that: To make college more affordable . . . let’s tell another one million students that when they graduate, they will be required to pay only 10 percent of their income on student loans, and all of their debt will be forgiven after 20 years—and forgiven after 10 years if they choose a career in public service, because in the United States of America, no one should go broke because they chose to go to college.
388. See Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 1076(a), 98 Stat. 494, 1053-54 (1984). Section 108(f) applies to discharges occurring on or after January 1, 1983, but similar treatment for earlier periods was provided by §2117 of the Tax Reform Act of
of this benefit will generally be employed in professions that pay lower salaries than can otherwise be earned in the public market, the value of the loan forgiveness benefit is intended to partially replace the amount of foregone revenue.

If the discharge is pursuant to a loan provision providing for complete or partial debt forgiveness if the individual worked for a certain period of time in certain professions for any of a broad class of employers, the amount discharged is excluded from gross income. Student loans repaid under the National Health Service Corps Loan Repayment Program or similar state programs similarly qualify. In addition, amounts received by individuals under any other State loan repayment or loan forgiveness program intended to provide for the increased availability of health care services in underserved or health professional shortage areas (as determined by such State) are similarly excluded from gross income.

For these purposes, a "student loan" means a loan made to an individual to assist the individual in attending an educational institution. For these purposes, an "educational institution" is defined in the same manner as for scholarships, but differently than for purposes of the student loan interest deduction. Accordingly, the interest on a loan that qualifies for tax-free loan forgiveness might not be deductible. In addition, the loan must be made by (1) the United States, or an instrumentality or agency thereof; (2) a state, territory or possession of the United States, or the District of Columbia, or any political subdivision thereof; (3) certain tax-exempt public benefit corporations; or (4) an educational organization if such loan is made (i)
pursuant to an agreement with any entity described in (1), (2) or (3) under which the funds from which the loan was made were provided to such educational organization, or (ii) pursuant to a program of such educational organization to encourage students to serve in occupations with unmet needs or areas with unmet needs. The term "student loan" also includes certain loans made to refinance an eligible student loan, but only if the refinanced loan is made by an educational institution or a tax-exempt entity pursuant to a program to encourage students to serve in occupations with unmet needs or areas with unmet needs.

D. Critiquing the Tax Incentive Provisions.

Prior to 1997, federal financial assistance for higher education was provided primarily through student grant and loan programs authorized under Title IV of the Higher Education Act of 1965, as amended. These programs include Pell Grants for low-income students, Parent Loan for Undergraduate Students (PLUS) loans to parents and graduate students, and Stafford loans. In fiscal year 2007, the Department of Education made available approximately $15 billion in grants and another $65 billion in Title IV loan assistance. Today, the Tax Incentive Provisions provide additional financial resources. In fiscal year 2007, such provisions cost the government an additional $8.7 billion.

While Title IV aid is larger in size, the Tax Incentive Provisions are wider in scope. In 2002, approximately 8.4 million students received either

394. I.R.C. § 108(f)(2). Income exclusion does not apply to the discharge of loans made by educational organizations or tax-exempt entities described in Section 108(f)(2)(D) if the discharge is on account of services performed for such organizations. See I.R.C. § 108(f)(3).


397. Id. Title IV also authorizes programs funded by the federal government and administered by participating higher education institutions, including the Supplemental Educational Opportunity Grant, Perkins loans, and federal work-study aid. Id. at 3-4.

398. Id. at 3.

399. See supra note 396. The Office of Management and Budget estimate takes into account revenue loss only from the Hope Scholarship Credit, the Lifetime Learning Credit, the Qualified Tuition Deduction, the student loan interest deduction, Section 529 plans and Coverdell ESAs. Estimates of revenue loss from all of the Tax Incentive Provisions for fiscal years 2009 through 2013 can be found, supra Part III.
a grant and/or a loan under a Title IV program. In the same year, approximately 9.6 million tax returns claimed a Hope Scholarship Credit, a Lifetime Learning Credit, or a Qualified Tuition Deduction. This does not reflect the magnitude of tax preferences in three respects. First, the 9.6 million figure reflects only three of the Tax Incentive Provisions discussed in this Article. Second, while the 8.4 million number is an unduplicated count of students (i.e., each student is counted only once regardless of the number of forms of Title IV aid received), the 9.6 million tax returns claiming one or more Tax Incentive Provisions reflects the number of tax returns—not the number of students—aided by these provisions. A single tax return may reflect tax incentives utilized by more than a single individual. Presumably, some returns encompass more than one student, meaning that the 9.6 million figure is only a starting point for the number of students helped by the Tax Incentive Provisions. Finally, incentives that provide an income exclusion (e.g., qualified scholarships) will never be reported on a tax return.

There are three major differences between Title IV assistance and the Tax Incentive Provisions: timing, demographic coverage, and individual responsibility. With respect to timing, Title IV aid generally is provided contemporaneously with the education, while the benefit of the Tax Incentive Provisions occurs before, during, and/or after the time the education takes place. With respect to demographic coverage, some Title IV programs provide much of their financial assistance to students and families whose incomes are lower, on average, than students and families who utilize the Tax Incentive Provisions. Finally, whereas federal government and educational institutions have significant responsibilities in assisting students

401. Id.
402. Id. at 13 n.11.
403. Id. at 14.
404. Id. In addition, Title IV grant and loan programs generally provide money to students when it is needed—at the time tuition and other expenses are due. Id. However, even the Tax Incentive Provisions that provide current benefit (i.e., the Education Tax Credits) have a delayed effect—that is, students are required to pay the expenses and seek “reimbursement” from the government when they file their tax returns claiming the incentive. A student that pays qualified educational expenses in January 2011 would not benefit from many of the Tax Incentive Provisions until filing her 2011 tax return in April 2012.
405. See Testimony of Michael Brostek, supra note 396, at 7-9. Director Brostek also stated that “92 percent of Pell financial support in 2003-2004 was provided to dependent students whose family incomes were $40,000 or below.” In contrast, in 2005, 60 percent of the benefit of the tuition deduction went to families with incomes exceeding $80,000. Id. at 8-10; see also supra note 290.
and families in obtaining aid under Title IV programs, students and families generally bear the burden of navigating the complexities of the Code.\textsuperscript{406} This complexity has prevented maximum utilization of the Tax Incentive Provisions.\textsuperscript{407}

Professor Halperin states that judging the appropriateness of the Tax Incentive Provisions is "an enormously complex subject, involving not only the effort to perfect the definition of income . . . but also matters as to the extent to which education should be subsidized, the effects of a tax allowance on the allocation of educational resources, and the redistribution of income or educational opportunity."\textsuperscript{408} Professor Chirelstein notes that the Tax Incentive Provisions have "nothing to do with 'tax policy' as such. As in so many other areas, it simply represents a willingness to use the tax law as a means of carrying out a national program that Congress deems worthy of support."\textsuperscript{409} When scrutinized from a tax policy perspective, the Tax Incentive Provisions have been evaluated in terms of their efficiency, equity, and complexity.\textsuperscript{410} Using these yardsticks, it is unclear that these provisions accomplish their stated goals.

\textsuperscript{406} See Testimony of Michael Brostek, \textit{supra} note 396, at 10-11.

\textsuperscript{407} Id. at 11. This is not a new concern. See Note, \textit{Federal Tax Incentives for Higher Education}, 76 Harv. L. Rev. 369, 374 (1962) (quoting Blum, \textit{How the Growth of Favored Tax Treatment Affects Taxpayers and Practitioners}, 4 J. Tax'n 28 (1956) (stating "the Internal Revenue Code already is complicated, and retention or addition of any tax benefit breeds added complexity and increases opportunities for error and abuse"); American Bar Association Section of Taxation, American Institute of Certified Public Accountants Tax Division, and Tax Executives Institute, \textit{Tax Simplification Recommendations} 6-7 (2001), available at http://www.abanet.org/tax/pubpolicy/2001/0102simpl.pdf (noting that "[f]or many taxpayers, analysis and application of the intended incentives are too cumbersome to deal with compared with the benefits received," and "there are so many individual tests that must be satisfied for each benefit, taxpayers may inadvertently lose the benefits of a particular incentive because they either do not understand the provision or because they pay tuition or other qualifying expenses during the wrong tax year"); see also Testimony of Michael Brostek, \textit{supra} note 396, at 11-12 (stating that "in total, including both those who failed to claim a tax credit or tuition deduction and those who chose a credit or a deduction that did not maximize their benefit, we found that in 2005, 28 percent, or nearly 601,000 tax filers did not maximize their potential tax benefit").

\textsuperscript{408} See Halperin, \textit{supra} note 169, at 903.

\textsuperscript{409} See Chirelstein \textit{supra} note 146, at 202. One of the dangers of using tax laws to carry out such policies is stated as follows:

Perhaps even more important, the indirectness of this method tends to remove the existence and amount of benefit from public scrutiny. This same indirectness may conceal the fact that within the economic activity being benefited, the aid may be irrationally allocated or insufficient; this possibility is heightened by the fact that Congress seldom reevaluates special tax benefits.

Note, \textit{supra} note 2, at 374.

“Policymakers currently attempt to enhance economic efficiency through tax provisions that promote a wide variety of behavior that they deem socially beneficial.”

Government subsidies promote higher education because market forces are inefficient to price in the positive externalities generated from such education. Higher levels of education correspond to lower rates of unemployment, poverty, use of public assistance programs, smoking, and crime. Higher levels of education also correspond favorably with higher tax revenues, higher participation rates in pension plans, higher levels of health insurance, better perceptions of individual health, higher levels of exercise, and greater civic participation. Furthermore, higher levels of education lead to greater productivity and national wealth. “[I]t is estimated that education and the innovation that arose from it accounted for two-thirds of the increase in U.S. economic growth.”

According to one report “[t]he economic benefits from contin-


412. HIGHER EDUCATION TAX CREDITS, at 1.

413. See EDUCATION PAYS 2007, supra note 6, at 18.

414. Id. at 19.

415. Id. at 20.

416. Id. at 22.


418. See EDUCATION PAYS 2007, supra note 6, at 9.

419. Id. at 15.

420. Id. at 16.

421. Id. at 21.

422. Id. at 23.

423. Including higher levels of participation in volunteer activities, blood donation, and voting. Id. at 25-27.


In his 2011 State of the Union address, President Obama noted that:

Maintaining our leadership in research and technology is crucial to America’s success. But if we want to win the future—if we want innovation to produce jobs in America and not overseas—then we also have to win the race to educate our kids. Think about it. Over the next 10 years, nearly half of all new jobs will require education that goes beyond a high school education. And yet, as many as a quarter of our students aren’t even finishing high school. The quality of our math and science education lags behind many other nations. America has fallen to ninth in the proportion of young people with a college degree. And so the question is
ued expansion in access to higher education could be substantial. Increasing the country's average level of schooling by one year could increase economic growth by 6% to 15%—adding between $600 billion and $1.5 trillion to U.S. economic output. The Tax Incentive Provisions are designed, in part, to encourage more investment in education than would occur in their absence. These incentives are efficient only if they increase investment in education. However, not much is known since many of these programs have not been properly studied or, where studied, the research reaches varying conclusions. Some studies find no measurable effects on college attendance and persistence, while others find positive effects.

Most commentators are also skeptical that the Tax Incentive Provisions promote equity. One such dissenting voice states:

A component of fairness in taxation is vertical equity, a concept which requires that tax burdens be distributed fairly among people with different abilities to pay. Tax credits benefit those who have sufficient income to pay tax. Those individuals without sufficient income to pay tax do not have the opportunity to benefit from education tax credits. The disproportionate benefit of tax expenditures to individuals with higher incomes reduces the progressivity of the tax system, which is often viewed as a reduction in equity.

The tax credits are regressive in that the more income taxpayers have, the more benefits they receive (up to the maximum phase out limits of the tax provision). As a result of their nonrefundable nature and the fact that the tax credits are not based on need, the tax credits move the distributional balance of federal aid away from low-income students towards middle-income students.

whether all of us—citizens, and as parents—are willing to do what’s necessary to give every child a chance to succeed.

See Press Release, Remarks by the President in State of the Union Address, supra, note 197.

425. See Descrochers, supra note 424.

426. See U.S. Gov’t Accountability Office, GAO-05-690, Tax Expenditures Represent a Substantial Federal Commitment and Need to Be Reexamined 55-56 (2005) (finding “[i]n the higher education area, the Department of Education . . . is unable to analyze the use of higher education tax credits or their effects because it lacks access to individual taxpayer data needed to identify users of the credits. Treasury has access to taxpayer data but has not used these data for evaluating the education tax credits since their implementation in 1998”).


428. See Jackson, supra note 410, at 16.
Other commentators also believe that the Tax Incentive Provisions are regressive in how the benefits of the provisions are distributed. Since, the value of the subsidy increases as the taxpayer’s marginal tax rate bracket increases, taxpayers in higher income brackets receive a greater share of the tax benefits. In low-income families, where the taxpayer pays no income tax, the Tax Incentive Provisions generally provide no benefit. Only the American Opportunity Tax Credit (which expires at the end of 2012) is refundable. The Tax Incentive Provisions can be made less regressive by imposing lower income limitations for eligibility (which will decrease the size and scope of the benefits) and by designing incentives as refundable credits rather than deductions.

Finally, the Tax Incentive Provisions do not promote simplicity. These provisions add complexity to the Code, raising administrative costs for which individuals, the federal government and educational institutions all bear the burden. The absence of uniform definitions, different income limitations for different incentives, and the Double Benefit provisions all add to complexity. None of the legislative history underlying these provisions explains the rationale for such poor integration of these provisions, and any explanation for the differences among these provisions is far outweighed by the resulting complexity. Taxpayers also must address

429. See generally Ryan, supra note 410, at 30-36; Oliver, supra note 201, at 137 (stating that “the TRA 1997 fails to meet the Congressional goal and the ideal of providing assistance to low-income families”).
430. See Oliver, supra note 146, at 137 (stating that “the distributional effects of the TRA 1997 are exactly the opposite of the intended goals. Families in the highest income bracket, $200,000 and over, have the greatest reduction in tax liability as a result of the TRA 1997. Families in the lowest income bracket receive no tax relief at all.”); Schenk, supra note 26, at 299 (concluding that “the incentives operate as a rebate of consumption other than education in ways that have disturbing distributional consequences”). See supra note 405.
431. See Ryan, supra note 410, at 30 (stating that “non-taxpayers are completely foreclosed from realizing any higher education subsidy from the education-related deduction and exclusions. In 2004, 35% of taxpayers had no positive income tax liability, and these same taxpayers housed almost half of all America’s children”); Thomas J. Kane, Savings Incentives for Higher Education, 51 NAT’L TAX J. 609, 618 (1998) (stating that “[b]ecause the tax credits are nonrefundable, the program is likely to have only modest effects on college enrollment rates, since the low-income families who are most sensitive to tuition costs and who are most likely to be on the margin of entering college are likely to benefit little”).
432. See supra Section III.A.1.
433. See JACKSON, supra note 410, at 17-20.
434. As discussed throughout this Article, taxpayers confronting the Tax Incentive Provisions have to deal with different definitions for which expenses qualify for the benefits of a particular provision, who constitutes an eligible student, and what institutions qualify as an eligible educational institution.
435. See generally Part III.
436. See STAFF OF JOINT COMM. ON TAX’N, JCX-35-08, PRESENT LAW AND ANALYSIS RELATING TO TAX BENEFITS FOR HIGHER EDUCATION 40 (Comm. Print 2008); see also discussion supra note 193.
uncertainties regarding the temporary nature of certain incentive provisions, and the fact that other provisions—since many of these provisions expire or are substantially modified after December 31, 2012 absent further congressional action.\footnote{437} This complexity leads to inefficiency in that taxpayers often do not claim the maximum benefits to which they are entitled.\footnote{438} Simplification of the Tax Incentive Provisions has been recommended numerous times.\footnote{439} However, to date, no such effort has garnered enough support.

\footnote{437} See Staff of Joint Comm. on Tax’N, JCX-35-08, Present Law and Analysis Relating to Tax Benefits for Higher Education 40 (Comm. Print 2008). As discussed throughout this Article, a number of amendments were made to the Tax Incentive Provisions as part of the enactment of EGTRRA. The amendments, however, were initially drafted so that such provisions terminated after December 31, 2010. \textit{See} EGTRRA, Pub. L. No. 107-16, § 901, 115 Stat. 38, 150 (2010). \textquote{[T]he Bush administration made extensive use of sunset provisions [i.e., provisions that expire after a period of time] while drafting [EGTRRA].}\textquote{Manoj Viswanathan, \textit{Sunset Provisions in the Tax Code: A Critical Evaluation and Prescriptions for the Future,} 82 NY L. Rev. 656, 660 (2007).}

While some of those provisions were permanently extended by the Pension Protection Act of 2006, most of these amendment remained effected, including (i) the ability of a taxpayer to claim an Education Tax Credit and an exclusion for qualified distributions from a Coverdell ESA in the same taxable year; (ii) the increase in the contribution limit for Coverdell ESAs from \$500 to \$2,000; (iii) the expansion of the definition of a \textquote{qualified education expense} with respect to distributions from Coverdell ESAs to include elementary and secondary school expenses; (iv) certain rules regarding coordination of distributions from Coverdell ESAs with distributions from qualified tuition programs; (v) rules extending deductibility of interest on student loans beyond the first 60 months of required interest payments; (vi) extension for the exclusion of employer-provided educational assistance, including assistance for graduate school tuition; (vii) inclusion of amounts received pursuant to the National Health Service Corps Scholarship Program and the Armed Forces Scholarship Program as qualified scholarships; and (viii) expanded income limitation levels provided in several of the Tax Incentive Provisions. \textit{See generally} Part III. In addition, the ARRA, which expanded the Hope Scholarship Credit into the American Opportunity Tax Credit, was set to expire after December 31, 2010. \textit{See} discussion supra, note 197.

The expiration of these provisions was delayed for a period of two years—until after December 31, 2012—by the enactment of the Tax Relief Act of 2010. \textit{See} Tax Relief Act of 2010, Pub. L. No. 111-312, §§ 101(a), 103(a), 124 Stat. 3296, 3298, 3299 (2010). However, such legislation was not enacted until just 17 days prior to the time that these provisions were set to expire. Such last-minute legislation creates a great deal of uncertainty for taxpayers, which prevents proper tax planning.

In addition, with respect to a provision such as the Qualified Tuition Deduction, which was retroactively extended almost one year after its expiration, taxpayers receive the benefit of a tax deduction for which their spending was not incentivized. \textit{See} Tax Relief Act of 2010, § 724 (which, on December 17, 2010, extended Section 222 which had expired for periods after December 31, 2009 for an additional two years).

\footnote{438} \textit{See} supra text accompanying note 407.

\footnote{439} \textit{See}, e.g., Staff of Joint Comm. on Tax’N, 107th Cong., JCS-3-01, Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986 122-31 (Comm. Print 2001) (recommending a single definition of qualified higher education expenses, combining the Education Tax Credits, and modifying the Double Benefit Rules); Staff of Joint Comm. on Tax’N, 108th Cong., JCS-3-04, Description of the Revenue
In theory, the Tax Incentive Provisions can increase efficiency. In practice, gains in efficiency have not been realized, as demonstrated by the research, while equity and simplicity in the Code have decreased. Although this Article recommends a simplification or elimination of the Tax Incentive Provisions, the presence or absence of these provisions in the Code neither enhances nor detracts from the proposal for a more significant reform of the tax treatment of higher education expenses.

IV. A FRAMEWORK FOR REFORM

A. Introduction

The current regulations and the courts apply a different standard, for purposes of Section 162, with respect to education expenses as compared to other business expenses. As discussed previously, this prevents a proper matching of income—providing an over-reporting of income in some cases, and an underreporting of income in other cases. The long history dealing with such expenses, beginning with the Service’s pronouncements that such amounts were nondeductible personal expenses, to the Supreme Court’s dicta in Welch that education will allow a taxpayer to “practice his vocation with greater ease and profit if he has an opportunity to enrich his culture,” to the court’s statement in Carroll that the education in question was a “per-

PROVISIONS CONTAINED IN THE PRESIDENT’S FISCAL YEAR 2005 BUDGET PROPOSAL 193-96 (Comm. Print 2004) (noting that, in 2004, President Bush recommended providing uniform definitions for qualified higher education expenses and qualified higher education institutions, eliminating the student loan interest deduction and the Qualified Tuition Deduction, and proposed treating student loan interest as a qualified expense for purposes of a per-student Lifetime Learning Credit); Education Tax Care Credit Simplification Act, H.R. 4136, 108th Cong. (2004) (proposing a single education credit of up to $3,000 and a uniform definition of qualifying higher education expenses); STAFF OF THE JOINT COMM. ON TAX’N, 109TH CONG., JCS-02-05, OPTIONS TO IMPROVE TAX COMPLIANCE AND REFORM TAX EXPENDITURES 42 (Comm. Print 2005), available at http://www.house.gov/jct/s-2-05.pdf (recommending combining the Education Tax Credits and the Qualified Tuition Deduction into a single credit that would be computed on a per-student rather than a per tax return basis in order to promote simplicity and fairness); Middle Class Opportunity Act of 2007, S. 614, 110th Cong. (2007) (proposing, among other things, to combine the Education Tax Credits into a single credit, allow a deduction for some books, use a standard definition of eligible student, increase the income limitations, and eliminate the Qualified Tuition Deduction); Bipartisan Tax Fairness and Simplification Act of 2010, S. 3018, 111th Cong. (2010) (proposing to combine the Education Tax Credits and to eliminate the separate deduction for student loan interest by folding such deduction into the new education tax credit). In addition to the recommendations cited in this paragraph, see the recommendations proposed by the American Bar Association Section of Taxation, supra note 407, at 7.

440. See infra Section IV.D.

441. See supra notes 61-62.

personal responsibility, and it provided extensive personal rewards,\(^443\) has led to regulations that categorize education as either a deductible business expense or a nondeductible expenditure that is either personal or an inseparable aggregate of personal and capital expenditures.\(^444\)

Professor Schoenfeld concluded that the current regulations are an unreasonable interpretation of Section 162(a).\(^445\) While this statement is true, this Article proposes a legislative fix as a result of the long history of disparate treatment for education expenses by the courts and the Service.

The recommendation proposed in this Article attempts to treat education expenses similarly to other expenses, providing for categories of nondeductible personal expenses, deductible business expenses, and amortizable business capital expenditures.\(^446\) Although an attempt was made to craft

----

\(^{443}\) Carroll v. Comm'r, 51 T.C. 213, 216 (1968), aff'd, 418 F.2d 91 (7th Cir. 1969).


\(^{445}\) See Schoenfeld, supra note 20, at 311.

\(^{446}\) There are few court cases addressing the amortization of education expenses. Such case law is irrelevant in analyzing the proposal since it is based on the history in this area and the current regulations treating such expenditures as being inherently personal. There is no legal prohibition to Congress amending the law to allow for an amortization deduction for certain education expenses as proposed herein.

In Sharon v. Commissioner, 66 T.C. 515, 525-27 (1976), aff'd, 591 F.2d 1273 (9th Cir. 1978), the taxpayer, a New York attorney, accepted a job with the IRS in California. Although not required by his employer, the taxpayer decided to become a member of the California bar. The taxpayer incurred expenses relating to a California bar review course, the bar examination, and fees to be admitted to practice law before the California courts. The taxpayer deducted both the costs of obtaining his law license in New York (including the cost of college and law school, a New York bar review course, and a New York state bar examination fee), as well as the costs incurred in obtaining admission to the California bar and courts. The Tax Court held that the New York educational expenses were neither deductible nor amortizable; rather such expenses were part of an "inseparable aggregate" that included personal expenditures because they satisfied the minimum educational requirements. \(\text{id. at 526 (citing Fausner v. Comm'r, 413 U.S. 838, 839 (1973).} \)

In addition, the court concluded that Section 262 took precedence over Section 167 in denying an amortization deduction. \(\text{id. at 526, (citing Comm'r v. Idaho Power Co., 418 U.S. 1, 17 (1974); Bodzin v. Comm'r, 509 F.2d 679, 681 (4th Cir. 1975).} \)

However, the taxpayer could amortize the license fee as a capital expenditure.

A similar result was reached concerning the expenses incurred in California. With respect to the California expenses, the Tax Court held that the cost of the bar review course was not deductible because it qualified the taxpayer for a new trade or business. However, the costs of acquiring his California law license, including bar examination and court admission fees, were capital expenditures that could be amortized over his life expectancy. Although the taxpayer argued that the useful life of such assets ended when he turned sixty-five, the court found insufficient evidence to establish such shorter useful life. \(\text{See also Huene v. Comm'r, 247 F. Supp. 564, 569 (S.D.N.Y. 1965) (where the taxpayer argued that he should be able to either deduct his law school and business school expenses, or amortize them over his working life. The court rejected these arguments, concluding "plaintiff cited no authority for this claim of amortization[,] . . . [and] I find none"); Denman v. Comm'r, 48 T.C. 439, 444-47 (1967) (where the Tax Court disallowed an amortization deduction for an engineering degree over a thirty-seven year useful life (beginning with graduation and ending}
a proposal that was pure—in the sense that the expenses would be matched accurately with the income that it produces—three factors have led to certain arbitrary lines being drawn. First, even those expenses with a direct and proximate relationship to a current or future business of the taxpayer contain both a business and personal element. Second, the useful life of education expenses may be difficult to determine. Finally, changing the tax treatment of education expenses would result in significant cost to the federal government. The remainder of this Article focuses on a legislative fix.

when the taxpayer turned sixty-five because of a lack of authority for such deduction); Hall v. Comm'r, 29 T.C.M. (CCH) 1363, 1364 (1970) (same with respect to college and law school expenses); Bodley v. Comm'r, 56 T.C. 1357, 1362 (1971) (same result where the taxpayer attempted to amortize his law school education over five years).

In Hyde v. Commissioner, 42 T.C.M. (CCH) 954, 963-64 (1981), the taxpayer claimed a depreciation deduction on his employment contract arguing that the cost of his college education should be used as the contract’s basis. The court denied the deduction, stating that the costs of a general college education were not deductible.

In Ducecater v. Commissioner, 60 T.C.M. (CCH) 917 (1990), the taxpayer attempted to amortize his law school education over five years under Section 195 as “start-up” costs of investigating and creating a trade or business in the practice of law. The Tax Court rejected this argument noting that if the taxpayer had been engaged in a trade or business, such expenses would have been nondeductible under Section 162 since they prepared him for a new trade or business. Since Section 195 only applies to expenses that would have been deductible had the taxpayer been carrying on a trade or business, a deduction was denied.

Professor Davenport notes the problem of drawing arbitrary lines, stating that:

Commentators generally agree that the courts have gotten the cost recovery issue wrong as to some types of education expenditures, for example, professional, vocational, and graduate education costs that seem clearly career-related and not to involve substantial personal consumption by almost any definition. There has been substantial disagreement, however, as to where to draw the line between those education expenditures that should be treated entirely as business-related and those that should be treated as involving some personal consumption.


Recognition of fiscal concerns in creating tax legislation is not a new concept—even in the area of education tax policy. For example, in reenacting Section 127 in 1996, the House Report for the Small Business Job Protection Act of 1996 notes that:

The need to balance the Federal budget necessitates some modification [of] the exclusion. . . . [T]he exclusion for employer-provided education should be targeted to those most in need of educational assistance—low- and middle-income employees who seek to obtain education which improves their skills and qualifies them for better jobs. Accordingly, the Committee believes it appropriate to reinstate the restriction on graduate-level education.

H.R. REP. NO. 104-586, at 80 (1996); see also supra note 271.

Legal scholars have considered the proper tax treatment of higher education expenses, with the general consensus that cost recovery for some of these expenses is appropriate. See, e.g., Richard Goode, Tax Treatment of Individual Expenditures for Education and Research, 56 AM. ECON. REV. 208 (1966); Bernard Wolfman, The Cost of Education and the Federal Income Tax, 42 F.R.D. 535 (1966); John K. McNulty, Tax Policy and Tuition
B. A Legislative Fix

1. Creating Categories of Education Expenses

Creating symmetry for education expenses under the Business Expense Deduction requires addressing two questions. First, which educational expenditures should be treated as personal expenses and which qualify as business expenses? Second, which business expenses are currently deductible and which qualify for capitalization?

With respect to the first question, only business expenses that are directly connected with or pertaining to a current or future trade or business of the taxpayer should qualify as a business expense. Where an expense contains both business and personal characteristics, such amounts should be categorized based upon their primary purpose. The courts have consistently resolved this issue by citing case law for the proposition that Section 262 takes precedence over Sections 162 and 167 and that no deduction is allowable because education expenses are an inseparable aggregate of personal and capital expenses. However, these courts interpret Fausner too narrowly. In Fausner, the Supreme Court concluded that, in some cases, an allocation of an expense between business and personal might be appropriate and a deduction for the portion allocated to the taxpayer’s trade or business would be allowable. A statutory solution for determining how to make such allocation would be no different than the line drawing that occurs in other areas.


451. This suggestion is borrowed from Treas. Reg. § 1.162-2(b), which treats traveling expenses as deductible business expenses if “the trip is related primarily to the taxpayer’s trade or business.”
452. See Sharon, 66 T.C. at 526 (citing Fausner, 413 U.S. at 839 (1973)).
453. Fausner, 413 U.S. at 839.
454. A number of commentators have noted that business travel is deductible although there may be a personal component to such expenditures. See, e.g., Halperin, supra note 169, at 862 (stating that “[i]f a deduction for entertainment expenditures reasonably
Since this Article is limited to post-secondary higher education, no discussion will be made regarding courses that are not part of a program leading to a degree. Regarding post-secondary higher education, most commentators have noted that the expenditures for most graduate, professional, technical and vocational education should be considered a business expense eligible for amortization.\(^4\) A more difficult problem is whether the expenditures for an undergraduate education also should so qualify.\(^4\) Here, commentators have taken different positions.\(^4\) Recognizing that some personal gains are derived from the education process, this Article takes the position that "on the whole, education remains an important... 

\(^4\) See, e.g., Davenport, supra note 447, at 215 (stating that "[p]rofessional, vocational, and graduate education, for example, are typically so closely related to career plans and involve so little "general cultural enrichment" or other personal components that their costs should be generally recoverable in full against one's future income, over some appropriate period and under some appropriate method"); Goode, supra note 449, at 211; McNulty, supra note 449, at 18; Argrett, supra note 449, at 653-54.

\(^4\) Professor Hume states:
Undergraduate degrees would create a battleground: an undergraduate liberal arts degree is such a general preparation for any number of professions as to be a clear case of a nondeductible outlay, but what about the student who gets an undergraduate degree in engineering or business? What about students who major in accounting or economics rather than history or philosophy? The Service would have to formulate a definition of 'vocational' or 'professional' to avoid continued litigation over such questions. The easiest definition to administer would probably exclude all degrees that offered more than a minimal mixing of disciplines, thereby excluding most undergraduate courses.

Hume, supra note 449, at 902.

\(^4\) Some commentators have supported treating undergraduate education entirely as a business expenditure. See, e.g., Goode, supra note 449, at 211 ("This rule would admittedly err on the side of liberality."); Wolfman, supra note 449, at 547; Paul B. Stephan III, Federal Income Taxation and Human Capital, 70 VA. L. REV. 1357, 1369 (1984); Argrett, supra, note 449, at 654; Pace, supra note 454, at 18. Other commentators would treat such education as a personal expense. See, e.g., Halperin, supra note 169, at 904 ("[E]ven the assumption of a large return on investment does not justify the deduction"); Alan Gunn, The Requirement That a Capital Expenditure Create or Enhance an Asset, 15 B.C. INDUS. & COM. L. REV. 443, 479 (1974) (stating that an undergraduate education provides personal satisfactions so great that it should be treated as a nondeductible personal expense). Professor Schultz offers a compromise: proposing to treat half of the cost of such education as a personal expense. See Theodore W. Schultz, Investment in Human Capital, 51 AM. ECON. REV. 1, 13 (1961).
means of increasing future earnings. As a result, legislation should draw the line by providing that, absent a showing that education was undertaken primarily for personal purposes, all education in a program leading to an undergraduate, graduate, professional or vocational degree should be considered a business expenditure.

With respect to the second question, business expenses will be considered currently deductible when such expenses do not provide significant benefits beyond the taxable year in which they are paid or incurred. When business expenses provide significant future benefits, capitalization is required. With respect to any course offered in a program leading to a degree, legislation should provide for capitalization based on the fact that a taxpayer who has earned a degree earns significantly more over her entire lifetime than a taxpayer with less education. While this bright-line rule might capture some courses that would otherwise entitle a taxpayer to a current deduction, there is a concern that a taxpayer may attempt to deduct the cost of a degree by taking courses piecemeal over a period of years.

2. What Expenses Qualify for Capitalization?

Qualifying expenses should include only tuition and fees required for the enrollment or attendance at eligible educational institutions, and any fees, books, supplies, and equipment required for courses of instruction.

458. Stephan, supra note 457, at 1369 (noting that “[p]arties, athletic events, and creative writing courses, for example, may be largely consumption rather than investment”).

459. An example of this might include a tax lawyer that takes classes to earn a masters degree in English literature. Like Professor Goode, this rule would err on the side of liberality. Goode, supra note 449, at 211.

460. See supra notes 6-15.

461. For example, a practicing accountant would be required to capitalize the cost of a single accounting course offered by a local university as part of masters in accounting program regardless of whether such taxpayer intends to complete the program and receive a degree.

462. The example in the previous footnote raises a concern that a taxpayer could attempt to deduct the cost of a masters degree in accounting by taking one course a semester and deducting such courses under the Business Expense Deduction.

463. A proposal to expand the scope of education expenses that qualify as business expenses (whether currently deductible or amortizable) also increases the amount of student loan interest that would constitute business interest. This raises the question of how such interest should be treated. To remain true to form, a deduction should be allowed for all student loan interest relating to currently deductible education expenses. With respect to deferred education interest, Section 263A would require capitalization of such interest until such time as the asset is placed in service (i.e., until the student begins working). Thereafter, the interest would be entitled to the Business Expense Deduction. See I.R.C. § 263A (2006); see also Comm’r v. Idaho Power Co., 418 U.S. 1, 17 (1974). With approximately $830 billion of student loan debt outstanding, allowing a current deduction for all interest paid would be cost prohibitive. See Mary Pilon, Student-Loan Debt Surpasses Credit Cards, REAL TIME ECONOMICS WALL ST. J. BLOG, Aug. 9, 2010, http://blogs.wsj.com/economics
This definition tracks the one currently used for qualified scholarships. Such definition excludes expenditures for room and board and other living expenses, as such amounts are clearly consumption expenses.

In order to prevent taxpayers from receiving a Double Benefit, the amount of qualified expenses must be reduced by the amount of such expenses that are deductible or used in computing any tax credit available under the Code. Similarly, qualifying expenses should be reduced to the extent that a taxpayer received any amount not includible in her gross income (such as amounts received as part of a qualified scholarship or as part of an employer-provided educational assistance program).

3. Method of Amortization

Qualifying education expenses should be amortizable on a straight-line basis over the taxpayer’s useful life with no recovery for unamortized costs that remain upon the taxpayer’s death or retirement from the workforce. Professor Argrett has noted that “[c]ourts generally have accepted the actuarial life span of the taxpayer as the appropriate period for the recovery of capital expenditures when the benefit from the expenditures will extend throughout the person’s lifetime.”

Although some commentators have argued that a shorter amortization period of time should be used,
amortization over the taxpayer's entire life is appropriate for two reasons. First, today many people work past the standard retirement age. Since a particular individual's retirement age is uncertain, there is no benefit to using the retirement age as a substitute. Second, amortization of higher education expenses will result in a significant revenue loss to the federal government. Requiring taxpayers to recover their education costs over a longer period will reduce the financial burden associated therewith.

Legislation would provide for amortization on a straight-line basis. Arguments could be made that education depreciates more during its early years, or that a greater portion of education should be allocated to a taxpayer's later years since "most taxpayers earn more in the years closest to retirement." However, since the Code amortizes most intangibles ratably over their useful life, a similar rule should be applicable to education expenses. Moreover, as Professor Argrett notes, "[b]ecause it would be difficult, or nearly impossible, to measure the decline in utility of this initial capital investment in education, the simplest approach would be to allow a straight-line cost recovery method."

Proposed legislation should disallow a deduction for unrecovered costs remaining upon a taxpayer's death or retirement prior to the time such costs are fully amortized. In this way, the proposal provides a treatment different than that for other capital expenditures. Three rationales exist

and the liberal treatment of research and development costs.

468. See infra Section IV.C.

469. For example, assume taxpayer who graduates college at age twenty-five with $100,000 in education expenses. Assume further that the taxpayer has a constant marginal tax rate of thirty percent. Amortizing such expenses over a forty-year useful life (i.e., until age sixty-five) would cost the Treasury $9,999 in present value terms (assuming a seven percent discount rate). Requiring such taxpayer to amortize these costs over his 57-year actuarial life expectancy would reduce the revenue loss by more than twenty-six percent ($7,355). In addition, using an actuarial life expectancy would prevent a sixty-six year old taxpayer who decides to seek an additional degree from deducting the costs in full as incurred.


472. See Argrett, supra note 449, at 655.

473. For a different view, see McNulty, supra note 449, at 32 ("All amortized expenses remaining at death could then be deducted in the last taxable year, much as the difference between depreciated costs and salvage value of a useless piece of depreciable property can be deducted from income in the year it is discarded. If a net loss resulted, a carry-back to prior taxable years could even be allowed. Similar treatment would be justified for a person who becomes unemployably disabled."); Goode, supra note 449, at 212 ("Provision would
for this disparate treatment. First, prohibiting accelerated cost recovery would limit the revenue loss resulting from this proposal. Second, education provides taxpayers with personal benefits that are retained following retirement. Finally, a bright-line prohibition would eliminate certain practical issues. For example, what would be the proper tax treatment for a taxpayer that had previously retired, taken a write-off for unrecovered education expenses, and later decides to return to work? Conversely, how should the law treat a taxpayer that takes a temporary hiatus from the labor force? At what point, does a temporary hiatus become permanent?

4. **Who? When? Against What?**

Legislation should provide that the student is the party entitled to deduct or amortize the costs of any education expenses, regardless of whether the student or another person pays such expenses. This is necessary to ensure that the deduction is matched with the income associated with the education. Education expenses paid by another party on the student's behalf should be treated as a gift.

Any legislative proposal should provide that amortization of education expenses should begin upon the later of receiving the degree relating to such expenses and entering into a trade or business to which the education has a direct and proximate relationship. It is recognized that this might result in a factual inquiry in certain cases. For example, when does a taxpayer engaged as an accountant who attends law school in order to practice law begin amortizing the cost of her legal education: during the period she works as an accountant or only upon entering the legal profession? In those cases, if the education is directly and proximately related to the current trade or business, amortization should begin upon receiving the degree. If not, amortization would begin when the taxpayer enters the new trade or business. It is admitted that this rule might allow certain taxpayers to begin amortizing their education earlier than under an ideal income tax. However, the long amortization period required under this proposal would mitigate any significant distortion resulting from accelerating the recovery period.

Finally, the question arises as to what income should be offset with the amortized education expense deduction? Commentators that have considered this issue have concluded that the amortized deductions should only have to be made for late adjustment of the original estimate if earnings were prematurely ended by death, disability, or obsolescence.

474. See supra note 469; see infra Section IV.C.
475. See Goode, supra note 449, at 211; McNulty, supra note 449, at 26-27; Argrett, supra note 449, at 655.
offset income related to such education. The difficulty here is that "professional education may contribute to the earning of income outside the field for which the taxpayer was most directly trained." The solution is to allow taxpayers to amortize their educational expenses against their earned income. Under a pure tax system, taxpayers who do not have enough earned income to absorb the amortization deduction in any given year should be entitled to carry the net loss forward or back to offset income in other years. However, it is proposed that any excess amortization deductions for a tax year should be lost. Two benefits arise from this strict rule. First, limiting an amortization deduction to a single year might reduce the costs of this proposal. Second, such limitation would prevent taxpayers from being rewarded for education expenses that significantly exceed their earned income.

C. Costs of Amortizing Higher Education Expenses

Probably the most difficult issue in implementing this legislative proposal is determining and compensating for the revenue loss arising from a significant expansion of cost recovery for education expenses. Although this proposal is attempting to do no more than correctly account for the costs of higher education, it is unlikely that such proposal will be seriously considered if it causes a significant loss of revenue. As the figures indicate, allowing an amortization of education expenses need not cost as much as one would initially imagine.

Tuition and fees for all public degree-granting institutions for the 2007-2008 academic year were approximately $48 billion. This figure should be reduced by (i) the amount of scholarships and fellowships granted.

477. See, e.g., Davenport, supra note 447, at 914 (stating that "we could—and we should—appropriately limit use of accelerated depreciation deductions for human capital by providing that they may only reduce reasonably-related earned income"); McNulty, supra note 449, at 30.

478. McNulty, supra note 449, at 30 (noting that "[l]aw school training, for example, may benefit a taxpayer who later enjoys earnings in politics, business, government and other fields").

479. But see McNulty, supra note 449, at 30 (who notes that education may make a taxpayer a better investor, thereby increasing unearned income).

480. Because of the mixed business/personal nature of education expenses, an analogy can be made here to other provisions of the Code. See, e.g., I.R.C. § 183 (2006) (limiting deductions for hobby expenses to hobby income with no carryover provisions); I.R.C. § 165(d) (limiting gambling losses to current year’s gambling income).

481. See Education Statistics, supra note 24, at tbl.352. The term "degree-granting institutions" means those institutions that grant associates or higher degrees and participate in Title IV federal financial aid programs. This figure does not take into account such potentially amortizable expenses as books, supplies and equipment.
by such institutions (approximately $10 billion)\textsuperscript{482} and (ii) any awards granted to students under the Pell Grant Program (approximately $15 billion).\textsuperscript{483} The net amount of $23 billion would give rise to a net revenue loss of approximately $7 billion (assuming a weighted average marginal tax rate of 30 percent).\textsuperscript{484}

However, such estimate must be considered speculative for a number of reasons. First, it is unclear that a thirty percent weighted average marginal rate is the correct number to use. One economist states that such rate might be closer to twenty-four percent.\textsuperscript{485} Reducing the weighted average marginal tax rate from thirty percent to twenty-four percent would result in a twenty percent reduction of costs.

Second, the net figure of $23 billion does not take into account those expenses that would not qualify under the legislative proposal due to being personal expenses. Nor is the $7 billion cost reflective of the fact that certain of these expenses are deductible under current law. In addition, although the $23 billion of net tuition and fees is reduced by scholarships received from the school and amounts received from Pell Grants, such amount should be further reduced by any private scholarships or amount received by students under employer educational assistance programs. Similarly, to the extent that such expenses are used in computing another tax benefit (for example, an Education Tax Credit), the $23 billion will be further reduced.

In addition, to the extent that taxpayers are unable to take full advantage of the amortization allowance, the revenue loss resulting from this pro-

\textsuperscript{482} Id. at tbl.362.


\textsuperscript{484} This figure should be compared with the approximately $12 billion revenue loss estimate for fiscal year 2010 for the Education Tax Credits. See supra notes 188-189.

\textsuperscript{485} See Average Effective Marginal Tax Rates, GREG MANKIW’S BLOG: RANDOM OBSERVATIONS FOR STUDENTS OF ECONOMICS (Oct. 1, 2008), http://gregmankiw.blogspot.com/2008/10/average-effective-marginal-tax-rates.html (last visited June 4, 2011). In discussing the tax proposals of the 2008 Presidential candidates, Mankiw states that “[o]verall, the Obama plan would leave average effective marginal tax rates virtually unchanged at 24 percent whereas the McCain plan would lower the average EMTR to 23 percent.”); see also Cong. Budget Office, EFFECTIVE MARGINAL TAX RATES ON LABOR INCOME 1 (2005), available at www.cbo.gov/ftpdocs/68xx/doc6854/11-10-LaborTaxation.pdf, (stating that: “In terms of federal individual income taxes, most taxpayers face effective marginal rates of 15 percent or less. Less than one-fifth face rates of more than 25 percent, and about 7 percent of taxpayers face rates in excess of 30 percent . . . . If tax provisions enacted in 2001, 2003, and 2004 expire as scheduled [after 2010], marginal rates will increase across most of the income distribution. Compared with a fully phased-in version of existing law, expiration would raise effective marginal tax rates by an average of almost 3 percentage points.”).
posal will be decreased. In other words, amortization deductions lost as a result of taxpayers who die prior to their actuarial expected life or retire from the workforce will reduce the total cost of this proposal. Changes in enrollment, tuition prices and tax rates will also have an effect on the cost of providing a legislative fix. Finally, any loss of revenue resulting from amortization will be reduced by any increase in taxable income attributable to education undertaken as a result of increased tax subsidization.

Notwithstanding the foregoing, the revenue losses associated with revising the tax treatment for education expenses are significant. However, certain limitations could be implemented to mitigate these revenue losses. First, the $7 billion revenue loss estimate assumes full implementation of the program. If amortization of higher education expenses were prospective, the first year's revenue loss would be limited to a ratable share of $7 billion. Assuming a fifty-year useful life for such expenses, the first year's revenue loss would be approximately $140 million. In such case, revenue losses will continue to compound until full implementation, as additional years become eligible for cost recovery.

Second, the expenses for which amortization is allowable could be limited to tuition and fees, as these costs are more easily determinable and can be verified from educational institutions. Alternatively, Professor Argrett notes, "fiscal effects can be further limited by placing a cap on allowable expenses eligible for cost recovery at the various levels of higher education." An example of this would be to set the limit on deductible law school expenses for which amortization is allowed equal to the median costs incurred by all students at law schools for a given year. Not only would this reduce the revenue lost from this legislative proposal, but such a limit would also prevent students at expensive private schools from receiving a greater benefit than students at less expensive publicly supported ones. Furthermore, a cap on the amounts eligible for cost recovery would

486. See McNulty, supra note 449, at 33, (citing Goode, supra note 449, at 293-95.).
487. A fifty-year useful life assumes that the average age at which amortization begins for taxpayers is thirty-three. See Treas. Reg. § 1.72-9, tbl.5 (2011). Using a thirty-year amortization (assuming an average age of fifty-four) would increase the first year's revenue loss to approximately $230 million.

Present value was computed using a seven percent discount rate. The U.S. Office of Management and Budget uses a seven percent discount rate in evaluating Federal programs whose benefits and costs are distributed over time. See OFFICE OF MGMT. & BUDGET, EXEC. OFFICE OF THE PRESIDENT, OMB CIRCULAR No. A-94, REVISED (2009), available at http://www.whitehouse.gov/omb/circulars_a094#8.

The present value of amortizing $100,000 of education expenses for a 22-year old college graduate would be $7,020—assuming a thirty percent marginal tax rate, a 60-year useful life, and a seven percent discount rate. The present value for the same expenses for a 35-year old college graduate would be $8,582.
488. Argrett, supra note 449, at 657.
489. Id. However, Professor Argrett notes that:
make it less likely that institutions would raise their tuition and fees as a direct result of the legislation. 490

D. Coordination with the Tax Incentive Provisions

The Tax Incentive Provisions are inequitable, complicated, and, possibly, inefficient. 491 One solution would be to eliminate most of these incentives. Provisions such as the qualified scholarship exclusion, the exclusion for employer-provided educational assistance plans and the exclusion for student loan forgiveness could be retained solely out of a desire to achieve political palatability for a change to a long-standing policy of providing tax incentives for higher education. Additionally, the current rules providing for limited deductibility of student loan interest should be retained for fiscal reasons. 492 Repealing the remaining Tax Incentive Provisions would result in approximately $8.5 billion in savings for fiscal year 2011. 493 These savings would offset the cost of the legislative proposal discussed in this Article and could allow for additional direct aid for students that would be more efficient, equitable, and less confusing than the Tax Incentives Provisions such aid replaces.

This proposal attempts to be realistic, recognizing that widespread use of the Tax Incentive Provisions makes it politically challenging to effectuate their elimination. 494 If any such provisions are to be retained, it is suggested that all current tax incentives (other than those suggested to be retained pursuant to the preceding paragraph) be combined into a single deduction or credit using a single set of definitions. Thus, for example, a single $3,000 tax credit could be provided to taxpayers in lower- and middle-income tax brackets to be used for any tuition, fees, books, and supplies at qualified educational institutions.

A counter-argument to placing a cap on these expenditures is that students attending expensive private schools would be truly disfavored—as they would not be able to recover fully the costs of their education, which may in fact lead to higher earnings than if they had not attended these private schools—while students at publicly-supported schools would be able to recover their costs fully in many cases, as well as receiving a substantial tax-free subsidy through lower tuition and fees. Others may argue, however, that it is not unfair to place a cap on recoverable amounts because the excess amount paid by students who attend expensive private institutions ought to be viewed as consumption.

Id. at 657 n.208.

490. Id.

491. See generally discussion supra Section III.D.

492. See supra note 463.

493. See supra notes 188-89, 220, 276-277, 304, & 327.

494. See supra notes 400-402.
V. CONCLUSION

Under current law, there are two ways that a taxpayer who has incurred education expenses can receive a tax benefit with respect to such expenses. First, where the taxpayer has incurred ordinary and necessary expenses in connection with her trade or business, such expenses are deductible in full in the year paid or incurred. Second, expenses not qualifying for such a deduction might be eligible for a tax benefit as a result of certain Tax Incentive Provisions. The first route is inequitable, with complicated provisions that often result in taxpayers receiving a deduction that is either too large or too small. The second route is comprised of tax provisions that are inefficient, inequitable, and complicated.

The legislative solution proposed in this Article does not provide a perfect fix for the problems created by the current law. However, such a solution attempts to accomplish good tax policy by allowing taxpayers to offset the income they earn with the costs of the education that allowed for such earnings. This solution, however, is costly. But, by tinkering with the proposed legislative fix, the author believes that Congress could draft legislation that would allow for good tax policy at a sensible cost.