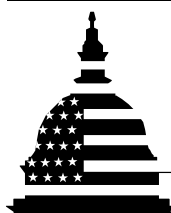


July 2005

# STUDENT AID AND POSTSECONDARY TAX PREFERENCES

## Limited Research Exists on Effectiveness of Tools to Assist Students and Families through Title IV Student Aid and Tax Preferences

This report was amended on November 17, 2005 to remove estimated median income data for households with Section 529 Qualified Tuition Program accounts or Coverdell Education Savings Accounts, due to a sample selection bias in the private sector research report that was our source. Median income estimates were removed from Table 2 and the text on page 18.



G A O

Accountability \* Integrity \* Reliability



Highlights of [GAO-05-684](#), a report to the Committee on Finance, U.S. Senate

### Why GAO Did This Study

Federal assistance helps students and families pay for postsecondary education through several policy tools—grant and loan programs authorized by title IV of the Higher Education Act of 1965 and more recently enacted tax preferences. In fiscal year 2004, about \$14 billion in grants and \$56 billion in loans were made under title IV while estimated outlay equivalents for postsecondary tax preferences amounted to \$10 billion. In light of the relative newness and financial significance of tax preferences, this report examines (1) how title IV assistance compares to that provided through the tax code, (2) the extent to which tax filers effectively use postsecondary tax preferences, and (3) what is known about the effectiveness of federal assistance.

### What GAO Recommends

GAO does not make new recommendations in this report. In 2002, GAO recommended, among other things, that Education sponsor research into key aspects of effectiveness of title IV programs. Little progress has been made by Education; however, according to the Department, it is in the process of establishing a postsecondary research center that will sponsor such research. Although Education disagreed with our conclusion about the extent to which title IV programs have been adequately studied, it agreed, as it did when we issued our 2002 report, that more research was warranted.

[www.gao.gov/cgi-bin/getrpt?GAO-05-684](http://www.gao.gov/cgi-bin/getrpt?GAO-05-684).

To view the full product, including the scope and methodology, click on the link above. For more information, contact Michael Brostek at (202) 512-9110 or Cornelia M. Ashby at (202) 512-7215.

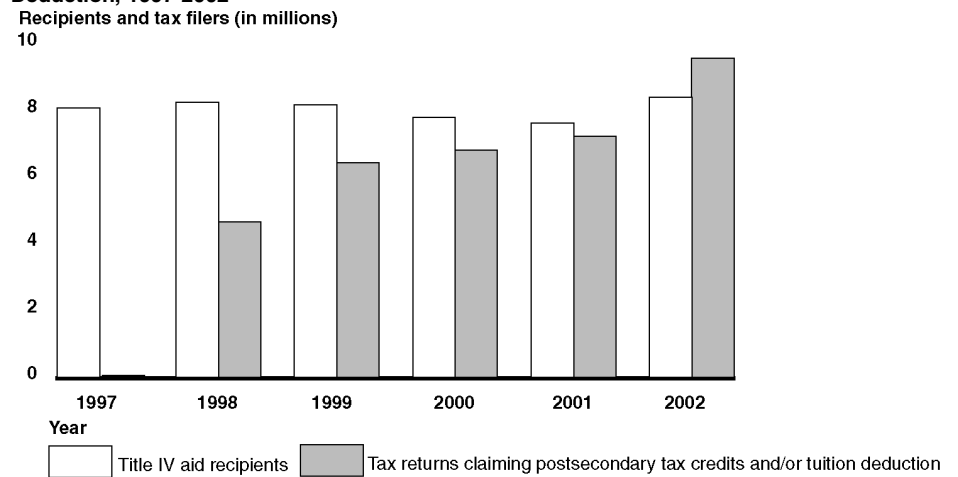
# STUDENT AID AND POSTSECONDARY TAX PREFERENCES

## Limited Research Exists on Effectiveness of Tools to Assist Students and Families through Title IV Student Aid and Tax Preferences

### What GAO Found

Title IV student aid and tax preferences provide assistance to a wide range of students and families in different ways. While both help students meet current expenses, tax preferences also assist students and families with saving for and repaying postsecondary costs. While both serve students and families with a range of incomes, some forms of title IV aid—grant aid, in particular—provide assistance to those whose incomes are lower, on average, than is the case with tax preferences. While both require students and families to fill out forms, tax preferences require more responsibility on the part of students and families because they must identify applicable tax preferences, understand complex rules concerning their use, and correctly calculate and claim credits or deductions. While the tax preferences are a newer policy tool, the number of tax filers using them has grown quickly, surpassing the number of students aided under title IV in 2002.

**Recipients of Title IV Assistance and Tax Filers Claiming an Education Tax Credit or Tuition Deduction, 1997-2002**



Source: GAO analysis of Budget of the United States Government, FY1994-2002 and Internal Revenue Service data 1994-2002.

Some tax filers do not appear to make optimal education-related tax decisions. For example, among the limited number of tax returns available for our analysis, 27 percent of eligible tax filers did not claim either the tuition deduction or a tax credit. In so doing, these tax filers failed to reduce their tax liability by \$169, on average, and 10 percent of these filers could have reduced their tax liability by over \$500. One explanation for these taxpayers' choices may be the complexity of postsecondary tax provisions, which experts have commonly identified as difficult for tax filers to use.

Little is known about the effectiveness of title IV aid or tax preferences in promoting, for example, postsecondary attendance or choice, in part because of research data and methodological challenges. As a result, policymakers do not have information that would allow them to make the most efficient use of limited federal resources to help students and families.

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**Abbreviations**

AQEE	adjusted qualified education expenses
EFC	expected family contribution
ESA	Educational Savings Accounts
FAFSA	Free Application for Federal Student Aid
FDL	Federal Direct Loan
FFEL	Federal Family Educational Loan
FWS	Federal Work-Study
GAO	Government Accountability Office
GED	General Educational Development
IRS	Internal Revenue Service
NPSAS	National Postsecondary Student Aid Study
PART	Program Assessment Rating Tool
PLUS	Parent Loans for Undergraduate Students
SEOG	Supplemental Educational Opportunity Grant
SOI	Statistics of Income
TIN	taxpayer identification number

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United States Government Accountability Office  
Washington, D.C. 20548

July 29, 2005

The Honorable Charles E. Grassley  
Chairman  
The Honorable Max Baucus  
Ranking Minority Member  
Committee on Finance  
United States Senate

In recent decades, Congress has provided billions of dollars in assistance each year to help the nation's students and families meet the costs of postsecondary education. In the past, this assistance has primarily been provided through student grant and loan programs authorized under title IV of the Higher Education Act of 1965, as amended. Much of this aid, called need-based aid, has been provided on the basis of the difference between a student's cost of attendance and an estimate of the ability of the student and the student's family to pay these costs, called the expected family contribution. More recently, however, postsecondary assistance has also been provided through a range of tax preferences,<sup>1</sup> including postsecondary tax credits, tax deductions, and tax-exempt savings programs. For example, the Taxpayer Relief Act of 1997 allows eligible tax filers to reduce their tax liability by receiving, for tax year 2005, up to a \$1,500 Hope tax credit and/or a \$2,000 Lifetime Learning tax credit for tuition and course-related fees paid. Furthermore, the 2001 Economic Growth and Tax Relief Reconciliation Act created a new tax deduction for tuition expenses, which eligible tax filers may use to deduct, in tax year 2005, up to \$4,000 from their taxable income for tuition and course-related fees paid.<sup>2</sup>

Providing federal financial assistance in these varied ways presents students and their families with an array of tools that may help them pay postsecondary education expenses. There is concern, however, that the postsecondary tax preferences create opportunities that are difficult for families to understand and use correctly. Additionally, Congress has been

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<sup>1</sup> Tax preferences—also known as tax expenditures—are reductions in tax liabilities that result from preferential provisions in the tax code, such as exemptions and exclusions from taxation, deductions, credits, deferrals, and preferential tax rates.

<sup>2</sup> Tax filers may claim only one of the tax preferences above for a single student. Families with more than one student with eligible expenses may claim more than one of these tax preferences.

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provided with little evidence concerning the effectiveness of assistance provided under title IV or through tax preferences, such as whether student assistance increases the rate at which students enroll in postsecondary education or whether assistance increases the likelihood that students will either earn a degree or continue their education (often referred to as persistence).

You asked us to explain how the federal government assists students and families in meeting the costs of postsecondary education, and to examine the opportunities and challenges associated with these policies. To address your interests, we answered the following questions: (1) How does title IV grant and loan assistance compare with that provided through the tax code? (2) To what extent are tax filers effectively using the opportunities presented by postsecondary tax preferences? (3) What is known about the effectiveness of federal assistance in promoting college attendance, providing students with a wider range of choices among postsecondary institutions, or encouraging students to persist in their studies?

To compare title IV federal grant and loan assistance with that provided through the tax code, we used Department of Education (Education) and Internal Revenue Service (IRS) data, as well as agency documents and statutory provisions describing federal student financial assistance programs and tax preferences related to student financial assistance for postsecondary education. For the purpose of this review, we focused on federal grant and loan programs or tax preferences that served 500,000 or more students and families. We also used two data sets, the 2003-2004 National Postsecondary Student Aid Study (NPSAS) from Education and IRS's 2002 Statistics of Income (SOI) individual tax file.<sup>3</sup> We analyzed SOI data to determine, among other things, whether tax filers made effective use of the Hope and Lifetime Learning tax credits and the tuition deduction. However, information required to analyze whether tax filers made effective use of the tax credits and deduction was not consistently available for tax filers included in the SOI data. Educational institutions must provide IRS and students with Forms 1098-T, which document students' enrollment status at the institution. Educational institutions may also, but are not required to, report on students' qualified tuition and

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<sup>3</sup> Both data sets report 2002 adjusted gross income. In this report, dependent student income equals 2002 parental adjusted gross income, while independent student income equals the student's 2002 adjusted gross income (and, if married, the spouse's adjusted gross income).



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related expenses, scholarships, and grants. Consequently, our analysis of SOI data for this purpose was limited to the approximately 1.8 million tax filers for whom Forms 1098-T reported such information. We were unable to determine whether these tax filers were representative of the approximately 12.4 million tax filers for whom such information was unavailable. To address issues of complexity as students and families use postsecondary tax preferences, we reviewed relevant statutes, regulations, and IRS documents, government reports, and academic research. We assessed the reliability of NPSAS and SOI data sets in light of our data reliability standards and found them to be useful for the purpose of this review. Details of our data reliability assessment and other aspects of our scope and methodology can be found in appendix I. To learn what is known about the effectiveness of federal grant and loan programs and tax preferences, we reviewed the academic literature on financial aid and education-related tax preferences. We conducted our review from May 2004 through June 2005 in accordance with generally accepted government auditing standards.

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## Results in Brief

In general, assistance is provided to a wide range of students and families under both title IV programs and through several tax preferences, but three key differences exist when comparing the two sources of aid. First, while title IV aid and tax preferences focus primarily on helping students meet current expenses, tax preferences also assist students and families with saving for and repaying postsecondary costs. Second, while student aid programs and tax preferences serve students and families across a wide range of income groups, some title IV programs—particularly the Pell Grant program—provide much of their financial assistance to students and families whose incomes are lower, on average, than students and families who receive student loans, tax credits and deductions, or who make use of tax-exempt saving vehicles. Last, while both title IV aid and tax preferences require students and families to fill out forms, tax preferences require more responsibility on the part of students and families for obtaining benefits because they must identify applicable tax preferences, understand complex rules concerning their use, and correctly calculate and claim credits or deductions on their returns.

Some tax filers do not appear to be making the most effective use of certain postsecondary tax preferences and, as a result, fail to minimize their federal income tax liabilities. Among tax filers included in the 2002 SOI data set for whom information indicating eligibility for an education tax credit or tuition deduction was available, 27 percent failed to claim either

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(1) a Hope or Lifetime Learning tax credit or (2) the tuition deduction. By not claiming an education tax credit or tuition deduction, we estimate that these tax filers failed to reduce their tax liabilities by \$169, on average. Furthermore, we estimate that 10 percent of these apparently eligible tax filers failed to reduce their tax liabilities by more than \$500. We also found that 21 percent of tax filers who claimed the tuition deduction would have reduced their tax liabilities by an additional \$83, on average, had they chosen to claim the Lifetime Learning tax credit rather than the tuition deduction. While tax filers' suboptimal choices may arise due to many factors, one reason may be the complexity of these tax provisions. Experts commonly identify postsecondary tax preferences as complex for tax filers to use because many of these preferences have similar objectives, dissimilar definitions, and rules that require extensive record keeping. Moreover, tax preferences can interact with title IV aid in a manner that affects the net amount of federal assistance received, adding to the complexity facing students and families. Students and families may make costly mistakes to the extent that they find using tax preferences to be difficult.

Little is known about the effectiveness of federal grant and loan programs and education-related tax preferences in promoting attendance, choice, and persistence. Many programs and tax preferences have not been studied, and even among those that have, important aspects of their effectiveness remain unexamined. When research exists, it suggests that federal programs and tax preferences have a range of results, from no measurable effects to modestly positive impacts on college attendance and persistence. Data and methodological challenges limit the certainty with which the effects of title IV programs and tax preferences, especially the latter, can be identified, and result in widespread gaps in knowledge of their effectiveness. Without this information, federal policy makers cannot weigh the relative effectiveness of postsecondary assistance provided through title IV and tax preferences. In 2002 we recommended, among other things, that Education sponsor research into the impact of title IV programs on postsecondary attendance and choice, completion, and college costs. Little progress has been made by Education; however, according to the department, it is in the process of establishing a postsecondary research center that will sponsor such research.

In commenting on a draft of this report, Education agreed overall that more research should be done on various federal programs that assist students enrolled in postsecondary education, but disagreed with our finding on the extent that title IV programs have been studied. Education also said that

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we should have included its research in our description of available program effectiveness research, including a particular study of the Pell Grant program. In general, while Education's research efforts—both the data collections conducted regularly by the agency and studies based upon those data—provide useful descriptive information, the data collections and related studies do not include information on those who do not receive postsecondary education and are therefore of limited use in establishing the effectiveness of title IV programs. Education's letter is reprinted in appendix IV. Also, IRS provided technical comments which we incorporated where appropriate.

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## Background

The federal government helps students and families save, pay for, and repay the costs of postsecondary education through grant and loan programs authorized under title IV of the Higher Education Act of 1965, and through tax preferences—reductions in federal tax liabilities that result from preferential provisions in the tax code, such as exemptions and exclusions from taxation, deductions, credits, deferrals, and preferential tax rates. In fiscal year 2004, Education made approximately \$14 billion in grants and provided another \$56 billion in loan assistance (face value) through the title IV programs. The fiscal year 2004 outlay equivalent cost of the postsecondary tax preferences reviewed in this study was estimated to be \$10 billion.

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## Federal Grant and Loan Assistance to Postsecondary Students

Assistance provided under title IV programs include Pell Grants for low-income students, parent loans known as PLUS loans, and Stafford loans.<sup>4</sup> While Pell Grants reduce the price paid by the student, student loans help to finance the remaining costs and are to be repaid according to varying terms. Stafford loans may be either subsidized or unsubsidized. The federal government pays the interest cost on subsidized loans while the

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<sup>4</sup> Consolidation loans are also authorized under title IV. These loans allow borrowers to combine multiple student loans, possibly from different lenders and from different loan programs, into a single new loan with extended repayment periods. Because consolidation loans do not generally result in an increase in loan principal, consolidation loans are not addressed in this review. However, the federal government can incur significant costs in providing borrowers with these loans. See GAO, *Student Loan Programs: As Federal Costs of Loan Consolidation Rise, Other Options Should Be Examined*, [GAO-04-101](#) (Washington, D.C.: Oct. 31, 2003) and *Student Loan Programs: Lower Interest Rates and Higher Loan Volume Have Increased Federal Consolidation Loan Costs*, [GAO-04-568T](#) (Washington, D.C.: Mar. 17, 2004).

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student is in school, and during a 6-month period known as the grace period, after the student leaves school. For unsubsidized loans, students are responsible for all interest costs.<sup>5</sup> Stafford and PLUS loans are provided to students through both the Federal Family Education Loan Program (FFELP) and the William D. Ford Direct Loan Program (FDLP). The federal government's role in financing and administering these two loan programs differs significantly. Under FFELP, private lenders, such as banks, provide loan capital and make loans, and the federal government guarantees FFELP lenders a minimum yield on the loans they make and repayment if borrowers default. Under FDLP, federal funds are used as loan capital and loans are provided through participating schools. The Department of Education and its private-sector contractors jointly administer the program. Title IV also authorizes programs funded by the federal government and administered by participating higher education institutions, including the Supplemental Educational Opportunity Grant (SEOG), Perkins loans, and federal work-study aid, collectively known as campus-based aid.

To receive title IV aid, students (along with parents, in the case of dependent students) must complete a Free Application for Federal Student Aid (FAFSA) form. Information from the FAFSA, particularly income and asset information, is used to determine the amount of money—called the expected family contribution (EFC)—that the student and/or family is expected to contribute to the student's education. Statutory definitions establish the criteria that students must meet to be considered independent of their parents for the purpose of financial aid, and statutory formulas establish the share of income and assets that are expected to be available for the student's education.<sup>6</sup> Once the EFC is established, it is compared with the cost of attendance at the institution chosen by the student. The cost of attendance comprises tuition and fees; room and board; books and supplies; transportation; miscellaneous personal expenses; and, for some

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<sup>5</sup> While called "unsubsidized," the federal government can still incur costs on such loans, including the costs associated with borrowers who default on their loans and, under the Federal Family Education Loan Program, the costs of making payments to lenders to ensure them a minimum federally guaranteed yield.

<sup>6</sup> To be classified as an independent student for the purpose of receiving title IV financial aid, students must meet one of the following criteria: (1) be a veteran of the armed services; (2) be age 24 years or older by December 31<sup>st</sup> of the award year; (3) be married; (4) be enrolled in a graduate or professional education program; (5) have legal dependents other than a spouse; or (6) be an orphan or ward of the court. Financial aid administrators may also classify students as independent through the exercise of their professional judgment.

students, additional expenses.<sup>7</sup> If the EFC is greater than the cost of attendance, the student is not considered to have financial need, according to the federal aid methodology. If the cost of attendance is greater than the EFC, then the student is considered to have financial need. Title IV assistance that is made on the basis of the calculated need of aid applicants is called need-based aid. Key characteristics of title IV programs are summarized in table 1, below.

**Table 1: Description of Federal Student Aid Programs Authorized under Title IV of the Higher Education Act**

Title IV student aid program	Program details	Annual award amounts	Number and characteristics of beneficiaries
Pell Grant	Grants are made on the basis of difference between the EFC and the maximum Pell award or the student's cost of attendance, whichever is less. Grants are not available for postgraduate study.	\$400 to \$4,050 for school year 2004-2005.	<p><b>Dependent students:</b> About 2.1 million grants were awarded in school year 2003-2004, totaling \$5.3 billion. The average grant award was \$2,573; the median income of recipients was \$24,576.</p> <p><b>Independent students:</b> About 3 million grants were awarded in school year 2003-2004, totaling \$7.4 billion. The average grant award was \$2,436; the median income of recipients was \$12,925.</p>
Supplemental Educational Opportunity Grant	Schools administer grant funds, which are made to undergraduates with exceptional financial need; priority is given to Pell Grant recipients. Institutions must match a portion (at least 25%) of the federal funds allocated.	\$100 to \$4,000.	<p><b>Dependent students:</b> About 554,000 grants were awarded in school year 2003-2004, totaling \$494.2 million. The average grant award was \$892; the median income of recipients was \$22,827.</p> <p><b>Independent students:</b> About 715,000 grants were awarded in school year 2003-2004, totaling \$391.9 million. The average grant award was \$548; the median income of recipients was \$11,040.</p>
Federal Work-Study	Schools administer funds, which are used to provide part-time jobs for undergraduate and graduate students with financial need. Participating schools or nonprofit employers generally contribute at least 25% of student's earnings (50% in the case of for-profit employers).	No annual minimum or maximum award amounts.	<p><b>Dependent students:</b> About 1.1 million awards were awarded in school year 2003-2004, totaling \$2 billion. The average award was \$1,901; the median income of recipients was \$46,441.</p> <p><b>Independent students:</b> About 438,000 awards were awarded in school year 2003-2004, totaling \$1 billion. The average award was \$2,303; the median income of recipients was \$10,561.</p>

<sup>7</sup> These may include child care expenses for parents of young dependent children or supportive services for disabled students.

(Continued From Previous Page)

Title IV student aid program	Program details	Annual award amounts	Number and characteristics of beneficiaries
Federal Perkins Loan	Schools administer funds, comprised of federal capital contributions and school matching funds (at least 1/3 of federal contributions), to make low-interest (5 percent) loans for both undergraduate and graduate students with exceptional financial need. Borrower repayments are owed to the school.	\$4,000 maximum for undergraduate students and \$6,000 for graduate students; no minimum award amount. (Aggregate limits: \$8,000 for undergraduates who have not completed 2 academic years; \$20,000 for undergraduates who have completed 2 years; and, \$40,000 for graduate students, including loans borrowed as an undergraduate.)	<b>Dependent students:</b> About 495,000 loans were made in school year 2003-2004, totaling \$956 million. The average loan amount was \$1,932; the median income of recipients was \$39,175.  <b>Independent students:</b> About 329,000 loans were made in school year 2003-2004, totaling \$905.3 million. The average loan amount was \$2,752; the median income of recipients was \$10,277.
Subsidized FFEL or Direct Stafford Loan	Loans made on the basis of financial need to undergraduate and graduate students who are enrolled at least half-time. The federal government pays the interest costs on subsidized loans while the student is in school, for the first 6 months after the student leaves school, and during a period of deferment.	\$2,625 to \$8,500 depending upon year of schooling. Aggregate limits are \$23,000 for undergraduates and \$65,500 for graduate students.	<b>Dependent students:</b> About 2.6 million loans were made in school year 2003-2004, totaling \$8.1 billion. The average loan amount was \$3,188; the median income of recipients was \$44,678.  <b>Independent students:</b> About 3.8 million loans were made in school year 2003-2004, totaling \$16.3 billion. The average loan amount was \$4,340; the median income of recipients was \$19,430.
Unsubsidized FFEL or Direct Stafford Loan	Loans made to undergraduate and graduate students who are enrolled at least half-time. Unlike subsidized loans, the federal government does not pay the interest costs on subsidized loans while the student is in school, for the first 6 months after the student leaves school, and during a period of deferment. Otherwise, the terms and conditions of unsubsidized loans are the same as those for subsidized loans.	\$2,625 to \$18,500 depending on year of schooling (including any subsidized loan amounts received for the same period). Aggregate limits are \$23,000 for dependent undergraduates, \$46,000 for independent undergraduates, and \$138,500 for graduate students.	<b>Dependent students:</b> About 1.6 million loans were made in school year 2003-2004, totaling \$5.3 billion. The average loan amount was \$3,293; the median income of recipients was \$75,835.  <b>Independent students:</b> About 3.3 million loans were made in school year 2003-2004, totaling \$18.5 billion. The average loan amount was \$5,671; the median income of recipients was \$22,108.
FFEL or Direct PLUS Loan	Loans made to parents on behalf of dependent undergraduate students enrolled at least half-time. Borrowers are subject to a credit check for adverse credit history and may be denied a loan.	Maximum loan amounts are limited to cost of attendance less other federal, state, private, and institutional aid received for the period of enrollment.	About 634,000 loans were made in school year 2003-2004, totaling \$5.7 billion. The average loan amount was \$9,019; the median income of recipients was \$71,397.

Source: GAO analysis of school year 2003-2004 NPSAS data.

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## Tax Preferences

Prior to the 1990s, virtually all major federal initiatives to assist students with the costs of postsecondary education were provided through grant and loan programs authorized under title IV of the Higher Education Act. Since the 1990s, however, federal initiatives to assist families and students in paying for postsecondary education have largely been implemented through the federal tax code. The federal tax code now contains a range of tax preferences that may be used to assist students and families in saving for, paying, or repaying the costs of postsecondary education. These tax preferences include credits and deductions, both of which allow tax filers to use qualified higher education expenses to reduce their federal income tax liability. The tax credits reduce the tax filers' income tax liability on a dollar-for-dollar basis but are not refundable. Tax deductions permit qualified higher education expenses to be subtracted from income that would otherwise be taxable. To benefit from a higher education tax credit or tuition deduction, a tax filer must use tax form 1040 or 1040A, have an adjusted gross income below the provisions' statutorily specified income limits, and have a positive tax liability after other deductions and credits are calculated, among other requirements.

Tax preferences also include tax-exempt savings vehicles. Section 529 of the tax code makes tax free the investment income from qualified tuition programs. There are two types of qualified tuition programs: savings programs established by states, and prepaid tuition programs established either by states or by one or more eligible educational institutions.<sup>8</sup> Another tax-exempt savings vehicle is the Coverdell Education Savings Account. Tax penalties apply to both 529 programs and Coverdell savings accounts if the funds are not used for allowable education expenses. Key features of these and other education-related tax preferences are described below, in table 2.

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<sup>8</sup> Certain aspects of the tax-favored treatment of section 529 programs that were enacted in the Economic Growth and Tax Relief Act of 2001 are subject to expire on December 31, 2010, if not extended.

**Table 2: Selected Postsecondary Education Tax Preferences**

Tax preference	Preference details			Tax benefit	Number and characteristics of beneficiaries
	Eligibility	Income ranges for phasing out benefits <sup>a</sup>	Eligible expenses		
Hope Credit	Tax filer on behalf of self, spouse, or dependent who is working toward a degree or certificate at least half-time in the first 2 years of postsecondary enrollment.	Single filer: \$42,000-\$52,000 Joint return: \$85,000-\$105,000. <sup>b</sup>	Tuition and fees at institutions eligible to participate in title IV programs.	Maximum credit: \$1,500 per student. Credit rate is 100 percent on first \$1,000 of qualified higher education expenses, 50 percent on next \$1,000.  Nonrefundable: if filer has no tax liability due to offsetting deductions, exemptions, or competing tax credits, filer cannot receive credit.	In tax year 2002, 3.3 million tax filers claimed \$3.2 billion in Hope credits; the average credit claimed was \$991, and the median income of filers claiming the credit was \$39,203.
Lifetime Learning Credit	Tax filer on behalf of self, spouse, or dependent who is enrolled in undergraduate or graduate courses, or any course that aids in learning new or improving existing job skills, for as many years as the student is enrolled.	Single filer: \$42,000-\$52,000 Joint return: \$85,000-\$105,000. <sup>b</sup>	Tuition and fees at institutions eligible to participate in title IV programs.	Maximum credit: \$2,000 per tax filer. (20 percent of qualified higher education expenses up to \$10,000).  Nonrefundable: if filer has no tax liability due to offsetting deductions, exemptions, or competing tax credits, filer cannot receive credit.	In tax year 2002, 3.5 million tax filers claimed \$1.7 billion in Lifetime Learning credits; the average credit claimed was \$477, and the median income of filers claiming the credit was \$39,706.
Student Loan Interest Deduction	Tax filer, on behalf of self, spouse, or dependent, available even to those who do not itemize interest paid. Student must have been enrolled at least half-time in a degree program.	Single filer: \$50,000-\$65,000 Joint return: \$100,000-\$130,000.	Eligible loans are those used to pay for tuition, fees, room and board, and related expenses and include, for example, student loans provided under title IV.	Maximum deduction: \$2,500 interest paid on eligible education loans is deductible.	In tax year 2002, 6.6 million tax filers deducted \$892.6 million of student loan interest; the average deduction was \$134, and the median income of filers deducting student loan interest was \$43,544.



(Continued From Previous Page)

Preference details					
Tax preference	Eligibility	Income ranges for phasing out benefits <sup>a</sup>	Eligible expenses	Tax benefit	Number and characteristics of beneficiaries
Section 529 qualified tuition programs—prepaid tuition programs and state-sponsored college savings programs <sup>c</sup>	Specifics depend on particular program. Normally a prepaid program is open for contributions only on behalf of young children and accounts must be closed within some number of years after the beneficiary reaches college age. Generally, savings programs do not have age restrictions.	No phaseout.	Tuition, fees, books, supplies, and equipment required for attendance. Room and board if enrolled half time or more.	No tax is due on a distribution from an account unless the amount distributed is greater than the beneficiary's adjusted qualified education expenses.	About 7.2 million prepaid tuition and college savings program accounts had been established by December 31, 2004, with a reported balance of \$64.7 billion in both types of programs.
Coverdell Education Savings Accounts	Distributions can be used for students enrolled on full-time, half-time, or less than half-time basis.  Account must be closed within 30 days after beneficiary reaches age 30.	For contributions, \$95,000-\$110,000 for single filers and \$190,000-\$220,000 for joint returns.	Tuition, fees, books, supplies, and equipment required for attendance. Room and board if enrolled half-time or more.	No tax is due on a distribution from an account unless the amount distributed is greater than the beneficiary's adjusted qualified education expenses.  Annual contribution limit is \$2,000 per year per student (through age 17).	Approximately 1 million contributions were made to accounts in tax year 2002.
Tuition Deduction (expires Dec. 31, 2005)	Same as Lifetime Learning credit.	Single filer: \$65,000-80,000 Joint Return: \$130,000-160,000.	Tuition and fees at institutions eligible to participate in title IV programs.	Maximum deduction: \$4,000 per return for individual filers whose modified adjusted gross income is less than \$65,000 (\$130,000 for joint filers); \$2,000 per return for individuals whose modified adjusted gross income is more than \$65,000 (\$130,000) but less than \$80,000 (\$160,000).	In tax year 2002, 3.4 million tax filers deducted \$1.3 billion; the average deduction was \$377, and the median income of filers using the deduction was \$54,326.

Sources: IRS and College Savings Plan Network; GAO analysis of IRS Statistics of Income data for tax year 2002

<sup>a</sup> Modified adjusted gross income amounts are provided.

<sup>b</sup> Under the Taxpayer Relief Act of 1997, the income phaseout amounts are indexed to inflation according to a formula specified in law for this purpose, which may or may not result in a yearly increase.

<sup>c</sup> The Economic Growth and Tax Relief Reconciliation Act of 2001 provides that from January 1, 2001 to December 31, 2011 eligible higher education institutions, in addition to states, may offer tuition prepayment programs. States remain the sole tax-exempt sponsors of college savings programs.

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Our review of tax preferences did not include exclusions from income, which permit certain types of education-related income to be excluded from the calculation of adjusted gross income on which taxes are based.<sup>9</sup> We also did not include special provisions in the tax code that also extend existing tax preferences when tax filers support a postsecondary education student.<sup>10</sup> Appendix IV lists all tax preferences reported by IRS, including ones not included in this review.

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## Tax Preferences Are More Recent Than Most Title IV Programs

Title IV programs have been in place for decades, while most education-related tax preferences were created much more recently. Between the late 1950s and the early 1980s each major federal initiative to assist students with the costs of postsecondary education was provided either through grant or loan programs. From 1981 through 1995 no new federal grant or loan-financing vehicles were adopted; however, new financing options, such as loan consolidation, and new delivery systems, such as direct student lending, were introduced for student loan programs. Since 1995, on the other hand, every federal initiative for the financing of postsecondary education has been implemented through the federal tax code, primarily through the Tax Relief Act of 1997 and the Economic Growth and Tax Relief Reconciliation Act of 2001. By 2002 the number of tax filers claiming a tax credit or tuition deduction was broadly comparable to the number of students aided through title IV programs: about 8.4 million students received a title IV grant and/or loan, and about 9.6 million tax

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<sup>9</sup> For example, scholarships covering tuition and fees and tuition reductions for the children of employees of an educational institution are not counted as income for income tax purposes. Similarly, student loans forgiven when a graduate goes into certain professions are also not subject to federal income taxes.

<sup>10</sup> For example, tax filers may claim postsecondary education students as dependents after age 18, even if the student has his or her own income over the limit that would otherwise apply. Also, gift taxes do not apply to funds used for certain postsecondary educational expenses, even for amounts in excess of the usual \$11,000 limit on gifts. In addition, funds withdrawn early from an Individual Retirement Account are not subject to the usual 10 percent penalty when used for either a tax filer's or his or her dependent's postsecondary educational expenses.

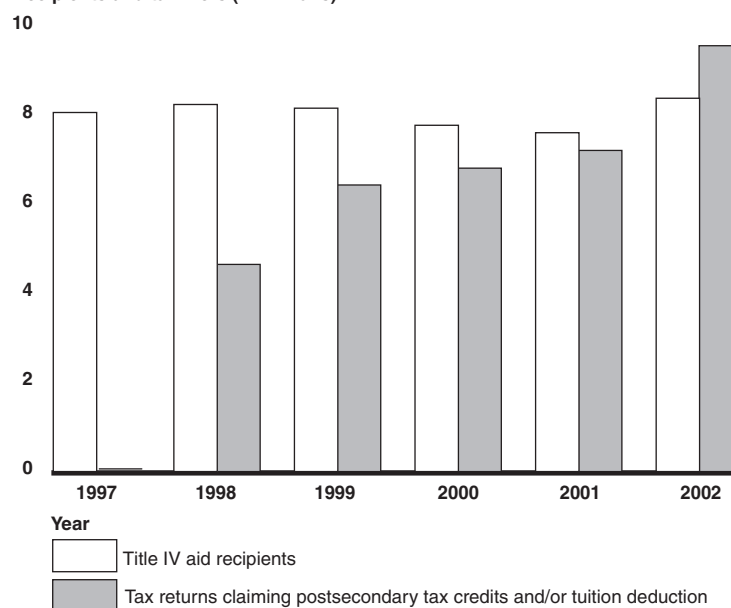
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filers filed returns claiming a Hope tax credit, Lifetime Learning tax credit, or tuition deduction. (See fig. 1.)<sup>11</sup>

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**Figure 1: Recipients of Title IV Assistance and Tax Filers Claiming an Education Tax Credit or Tuition Deduction, 1997-2002**

Recipients and tax filers (in millions)



Source: GAO analysis of Budget of the United States Government, FY1994-2002 and Internal Revenue Service data 1994-2002.

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<sup>11</sup> The 8.4 million title IV aid recipient figure is an unduplicated count of students, i.e., a student receiving both a grant and a loan is counted only once. Each of the 9.6 million tax filers represents at least one student and in some cases more than one student. A tax filer with more than one dependent with qualified educational expenses, or with qualified expenses of his or her own along with those of a dependent, may claim more than one tax preference on his or her tax return as long as other eligibility criteria are met.

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## Tax Preferences Differ from Title IV Assistance in Timing, Distribution, and Students' and Families' Responsibility for Obtaining Benefits

Postsecondary student financial assistance provided through programs authorized under title IV of the Higher Education Act and the tax code differ in three key ways. First, tax preferences and title IV programs differ in the timing and the distribution of benefits they provide. Title IV grant and loan programs primarily provide aid to students and families while students are in college, whereas tax preferences help both during the college years and before and after college by assisting with saving for or repaying college costs. Additionally, although student aid programs and tax preferences assist students and families across a wide range of income levels, some title IV programs, such as the Pell Grant and subsidized Stafford student loan programs, provide much of their financial assistance to students and families whose incomes are lower, on average, than students who receive unsubsidized Stafford loans, tax deductions, or make use of tax-exempt saving vehicles. Last, students and families have more responsibility for appropriately using and thereby obtaining the benefits of tax preferences compared with title IV aid.

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## Tax and Title IV Programs Differ in Benefit Timing

Title IV programs and education-related tax preferences differ significantly as to when eligibility is established and in the timing of the assistance they provide. Eligibility for title IV programs is generally established at the time of enrollment and prior to each subsequent school year thereafter, and title IV programs generally provide benefits to students while they are in school. Education-related tax preferences reach widely across the life span. They encourage saving for college, especially among families with dependent children through tax-exempt saving; assist enrolled students and their families in meeting the current costs of postsecondary education through credits and a tuition deduction; and assist students and families repaying the costs of past postsecondary education by allowing tax filers to claim a deduction for student loan interest paid. Thus, tax filers must determine their eligibility for these preferences every year that contributions are made to Coverdell Education Savings Accounts or every year that a former student claims a student loan interest deduction. Table 3 shows a comparison of the timing of title IV assistance and the assistance provided through various tax preferences.

**Table 3: Comparison of Assistance by Timing of Benefit for Selected Programs and Tax Preferences**

Type of assistance	Save for future expenses	Pay current expenses	Repay expenses
Grant programs		Pell Grants Supplemental Educational Opportunity Grants	
Loan programs		Subsidized and Unsubsidized Stafford Loans Federal Perkins Loans Federal PLUS Loans	
Tax preferences	Coverdell Educational Savings Accounts Section 529 Qualified Tuition Programs	Hope Credit Lifetime Learning Credit Tuition Deduction	Student Loan Interest Deduction
Work-Study program		Federal Work Study	

Source: GAO.

## Beneficiaries of Title IV Programs and Tax Preferences Differ

While title IV programs and tax preferences assist many students and families, a variety of program and tax rules affect students' and families' eligibility for such assistance. These rules also affect the distribution of title IV aid and the assistance provided through tax preferences. As a result, the beneficiaries of title IV programs and tax preferences differ, as discussed below.

### Title IV Assistance

Title IV programs have rules for calculating grant and loan assistance that give different consideration to family income, assets, and college costs in the award of financial aid.<sup>12</sup> Pell Grant awards are calculated by subtracting the student's expected family contribution (EFC) from the maximum Pell Grant award (\$4,050 in academic year 2004-2005), or the student's cost of attendance, whichever is less. Because the expected family contribution is closely linked to family income and circumstances (such as the size of the family and the number of dependents in school), and modest EFCs are required for Pell eligibility, Pell awards are received primarily by families with modest incomes. The maximum subsidized Stafford loan that a

<sup>12</sup> Campus-based aid programs authorized under title IV differ from these programs in funding and eligibility: institutions provide matching funding for federal spending, and participating institutions distribute aid using institution-specific criteria consistent with federal program requirements. Because they have institution-specific criteria, the relationship between program rules and the distribution of benefits is more complex and excluded from our analysis.

student may obtain is based upon his or her cost of attendance, minus the expected family contribution and the estimated financial assistance that the student will receive.<sup>13</sup> For a given cost of attendance, therefore, the amount of a subsidized Stafford loan increases as EFC decreases. In contrast, the maximum unsubsidized Stafford loan amount is calculated without direct consideration of financial need: students may borrow up to their cost of attendance, minus the estimated financial assistance they will receive.<sup>14</sup>

The different award rules for Pell Grants and subsidized and unsubsidized Stafford loans result in different patterns of program participation among students of different incomes, and different distributions of dollar support among students. As table 4 shows, 92 percent of Pell financial support in 2003-2004 was provided to dependent students whose family incomes were \$40,000 or below, and the 38 percent of Pell recipients in the lowest income category (\$20,000 or below) received a higher share (48 percent) of Pell financial support. With respect to subsidized Stafford loans, 67 percent of recipients had family incomes of \$60,000 or less and received a proportional share of total subsidized loan volume. In contrast, 65 percent of unsubsidized Stafford loan recipients had family incomes above \$60,000 and received 69 percent of total unsubsidized loan volume.

**Table 4: Percentage of Aid Recipients and Dollars of Aid by Income Category for Dependent Students Served by Selected Title IV Programs**

<b>Program</b>	<b>Dependent students</b>	<b>\$0-20,000</b>	<b>\$21,001-40,000</b>	<b>\$40,001-60,000</b>	<b>\$60,001-80,000</b>	<b>\$80,001-100,000</b>	<b>More than \$100,000</b>
Pell Grant	Recipients	38	47	14	2	0	0
	Dollars	48	44	8	1	0	0
Stafford Subsidized Loan	Recipients	16	28	23	17	9	7
	Dollars	16	28	24	17	9	6
Stafford Unsubsidized Loan	Recipients	7	14	14	19	18	28
	Dollars	7	12	12	18	19	32

Source: GAO analysis of 2003-2004 NPSAS data.

<sup>13</sup> Estimated financial assistance includes the Pell Grant and most other sources of state, federal, private, and institutional aid.

<sup>14</sup> Additionally, loan amounts for both subsidized and unsubsidized loans are subject to statutory limits on annual and cumulative borrowing.

Notes: See appendix II for confidence intervals associated with these estimates.

Numbers in rows may not add to 100 percent because of rounding.

Because independent students generally have lower incomes and accumulated savings than dependent students and their families, patterns of program participation and dollar distribution differ. Participation of independent students in Pell, subsidized Stafford, and unsubsidized Stafford loan programs is heavily concentrated among those with incomes of \$40,000 or less: from 74 percent (unsubsidized Stafford) to 95 percent (Pell) of program participants have incomes below this level. As shown in table 5, the distribution of award dollars follows a nearly identical pattern.

**Table 5: Percentage of Aid Recipients and Dollars of Aid by Income Category for Independent Students Served by Selected Title IV Programs**

Program	Independent students	\$0-20,000	\$21,001-40,000	\$40,001-60,000	\$60,001-80,000	\$80,001-100,000	More than \$100,000
Pell Grant	Recipients	67	28	5	0	0	0
	Dollars	73	25	3	0	0	0
Stafford Subsidized Loan	Recipients	51	29	12	5	2	1
	Dollars	52	28	12	5	2	2
Stafford Unsubsidized Loan	Recipients	46	28	14	6	3	3
	Dollars	46	24	13	7	3	5

Source: GAO analysis of 2003-2004 NPSAS data.

Notes: See appendix II for confidence intervals associated with these estimates.

Numbers in rows may not add to 100 percent because of rounding.

## Tax Preferences

Many education-related tax preferences have both de facto lower limits created by the need to have a positive tax liability in order to obtain their benefit and income ceilings on who may use them. For example, the Hope and Lifetime Learning tax credits require that tax filers have a positive tax liability to use them and income-related phase-out provisions in 2004 that begin at \$42,000 and \$85,000 for single and joint filers, respectively. The income-related phase-out provision for the tuition deduction, in comparison, begins in 2004 at \$65,000 and \$130,000 for single and joint filers, respectively. As a result, the majority of tax filers claiming the Hope and Lifetime Learning tax credits in 2002 had incomes under \$40,000. Among those who claimed the tuition deduction, in contrast, 38 percent of tax filers had incomes in this range, while 62 percent had incomes over \$40,000. Table 6 shows the income categories of tax filers claiming the

three tax preferences available to current students and/or their families along with the distribution of dollars through those preferences in 2002.

The reduction in tax liability associated with the use of the Hope and Lifetime tax credits also differs from that associated with the use of the tuition deduction. In 2002 tax filers claimed Hope credits worth about \$3.2 billion and Lifetime Learning credits totaling about \$1.7 billion. As shown in table 6, below, about 80 percent of the 2002 Hope and Lifetime credits' reduction in tax liability went to tax filers with incomes between \$20,001 and \$80,000. The distribution of benefits for the tuition deduction shows a substantially different pattern: more than half (52 percent) of the approximately \$1.3 billion reduction in tax liability associated with the use of the deduction in 2002 went to families with incomes of \$80,001 and above.

**Table 6: Percentage of Tax Filers Claiming Hope and Lifetime Learning Credits and Tuition Deduction and Tax Preference Dollars by Income Category, Tax Year 2002**

Type of aid		\$0-20,000	\$20,001-40,000	\$40,001-60,000	\$60,001-80,000	\$80,001-100,000	More than \$100,000
Hope Credit	Tax filers	18	33	20	18	11	0
	Dollars	10	33	23	24	10	0
Lifetime Learning Credit	Tax filers	16	34	25	16	8	0
	Dollars	12	34	25	21	7	0
Tuition Deduction	Tax filers	20	18	16	13	16	17
	Dollars	11	10	13	14	23	29

Source: GAO analysis of 2002 SOI data.

Notes: See appendix II for confidence intervals associated with these estimates.

Numbers in rows may not add to 100 percent because of rounding.

Although many families are eligible to participate in tax-exempt savings programs, the programs are more advantageous to those with higher incomes and tax liabilities. Families with higher than average incomes are more likely to use tax-exempt savings opportunities for a range of reasons, including, among others, that (1) these families hold greater assets to invest in these vehicles; (2) these families have a higher marginal tax rate, and thus benefit the most from the use of these vehicles; and (3) higher-income



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families may gain a reduction in tax liability even if withdrawals are not used for postsecondary expenses.<sup>15</sup>

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### Students and Families Have More Responsibility for Obtaining Benefits of Tax Preferences in Comparison to Title IV Aid

The federal government and postsecondary institutions have significant responsibilities in assisting students and families in obtaining assistance provided under title IV programs but only minor roles with respect to tax filers' use of education-related tax preferences. To obtain federal student aid, applicants must first complete the FAFSA form, which in its 2004 paper version was over eight pages long and contained more than 100 questions. While concerns have been raised that the FAFSA application may deter potentially eligible students from participating in title IV grant and loan programs,<sup>16</sup> filling out the FAFSA and submitting it to the Department of Education completes, by and large, students' and families' responsibility in obtaining aid. To benefit from title IV programs, students need not learn the rules of the federal student aid methodology, eligibility rules for individual programs, or understand the ways in which federal student aid programs interact with one another. Rather, the Department of Education is responsible for calculating students' and families' EFC on the basis of the FAFSA, and a student's educational institution is responsible for determining aid eligibility and the amounts and packaging of aid awards. In addition, title IV educational institutions assist Education in verifying the information submitted on the FAFSA form for a sample of aid applicants.

Higher education tax preferences, in contrast to federal grants and student loans, require more responsibility on the part of students and families. Although postsecondary institutions provide students and IRS with information about higher education attendance, they have no other responsibilities for higher education tax credits, deductions, or tax-preferred savings. The federal government's primary role with respect to higher education tax preferences is limited to the promulgation of rules;

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<sup>15</sup> The earnings portion of a withdrawal from a Coverdell Education Savings Account is taxed at the student's marginal rate, rather than the rate of the parents. For parents with more than \$100,000 in household income, nonqualified withdrawals from such an account, even with a 10 percent tax penalty, are taxed at a lower rate than withdrawals from a nonadvantaged account. See Susan Dynarski, *High Income Families Benefit Most from New Education Savings Incentives*, Tax Policy Issues and Options, No. 9 (February 2005).

<sup>16</sup> Advisory Committee on Student Financial Assistance, *The Student Aid Gauntlet, Final Report of the Special Study of Simplification of Need Analysis and Application for Title IV Aid*, (January 2005). Kane (1995) suggests that providing better information about financial aid and streamlining the process of applying for aid could increase enrollment.

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the provision of guidance to tax filers; and to the processing of tax returns, including some checks on the accuracy of items reported on those tax returns. In contrast, the primary responsibility for selecting among and properly using tax preferences rests with tax filers: they must understand the rules in light of their own situation, identify applicable tax preferences, understand how these tax preferences interact with one another and with federal student aid, keep records sufficient to support their tax filing, and correctly claim the credit or deduction on their return.

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### Some Tax Filers May Not Effectively Use Postsecondary Tax Preferences, Possibly Due to Complexity

According to our analysis of IRS data on the use of Hope and Lifetime tax credits and the tuition deduction, some tax filers appear to make less-than-optimal choices among them. The apparently suboptimal use of postsecondary tax preferences may arise, in part, from the complexity of using these provisions; however, our analysis of tax data does not permit us to identify why they are making these choices. Tax policy analysts consistently identify postsecondary tax preferences as a set of tax provisions that demand a particularly large investment of knowledge and skill on the part of students and families or expert assistance purchased by those with the means to do so.<sup>17</sup> Additional complexity associated with the use of postsecondary tax preferences also arises from the interaction of tax preferences and title IV student aid.

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### Some Tax Filers Appear to Make Suboptimal Choices

Making poor choices among tax preferences for postsecondary education may be costly to tax filers. For example, families may strand assets in a tax-exempt savings vehicle and incur tax penalties on their distribution if their child chooses not to go to college. They may also fail to minimize their federal income tax liability by claiming a tax credit or deduction that yields less of a reduction in taxes than a different tax preference or by failing to claim any of their available tax preferences. For example, if a married couple filing jointly with one dependent in his/her first 2 years of college had an adjusted gross income of \$50,000, qualified expenses of \$10,000 in

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<sup>17</sup> See, for example, U.S. Congress, Joint Committee on Taxation, *Study of the Overall State of the Federal Tax System*, vol. II (April 2001); U.S. Congress, Joint Committee on Taxation, *Present Law and Analysis Relating to Tax Benefits for Higher Education* (July 21, 2004); Nina E. Olson (National Taxpayer Advocate), “Complexity, Compliance, and Communication: Why Should Tax Filers Comply in a Complex and Changing Tax Environment?” (presentation before the President’s Advisory Panel on Federal Tax Reform, Mar. 3, 2005).

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2004, and tax liability greater than \$2,000, their tax liability would be reduced by \$2,000 if they claimed the Lifetime Learning credit but only \$1,500 if they claimed the Hope credit.

To assess whether tax filers faced difficulty with choosing among these preferences, we examined whether tax filers who were confronted with a relatively common tax choice—whether to claim the Hope or Lifetime Learning credit or the tuition deduction—chose the tax preference that minimized their tax liability. We analyzed information that IRS was provided with by educational institutions using Form 1098-T and tax return information in IRS’s 2002 Statistics of Income sample. Because 87 percent of Form 1098-T returns did not contain educational expense information, we were able to analyze only the remaining 13 percent of tax returns (representing about 1.8 million returns) in the SOI sample that received a Form 1098-T and contained information concerning students’ educational expenses. We were unable to determine if this 13 percent of returns is representative of the entire population of Form 1098-Ts. (See appendix I for details.) All estimates and their associated confidence intervals can be found in appendix II.

We found that some people who appear to be eligible for tax credits and/or the tuition deduction did not claim them. The filers of about 77 percent of the tax returns that we were able to review were apparently eligible to claim one or more of the three tax preferences: the tax filers appear to have had a positive income tax liability, qualified educational expenses, an adjusted gross income below statutory phase-out limits, and were otherwise eligible.<sup>18</sup> Among filers who were apparently eligible to claim one of the three tax preferences, 27 percent, representing about 374,000 tax filers, failed to do so. The amount by which these tax filers failed to reduce their tax averaged \$169; 10 percent of this group could have reduced their tax liabilities by over \$500.

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<sup>18</sup> We examined whether tax filers had (1) tax liability after claiming other tax credits, (2) net educational expenses after accounting for scholarships and grants as reported on the Form 1098-T, and (3) taxable income under program thresholds for tax year 2002. We also examined whether tax filers were married filing separately or filed a Form 1040EZ because this would prevent tax filers from being able to claim the education tax credits or tuition deduction. We were unable to consider other possible explanations, including whether tax filers did not meet certain qualification requirements, such as, in the case of the Hope tax credit, whether the student was in his or her first 2 years of postsecondary education. Eligibility for more than one tax preference for the same student does not mean that a tax filer may claim more than one—the tax filer must choose just one of the three tax preferences we discuss here per student.

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Some tax filers used a higher education tax credit or the tuition deduction but chose one that yielded a smaller reduction in their tax liability than they could have otherwise realized.<sup>19</sup> Among those who claimed the tuition deduction, we estimate that 21 percent (representing about 51,000 tax filers) would have been better off claiming the Lifetime Learning tax credit while 8 percent (representing about 22,000 tax filers) of those claiming the Lifetime Learning credit would have reduced their taxes by a greater amount if they had claimed the tuition deduction instead. The average amount by which these tax filers failed to reduce their taxes was \$83 for tax filers claiming the tuition deduction and \$138 for those claiming the Lifetime Learning credit. Some tax filers making these decisions failed to realize larger reductions in their tax liabilities—10 percent of suboptimal tuition deduction claimants could have reduced their tax liabilities by about \$158 or more and 10 percent of suboptimal Lifetime Learning credit claimants could have reduced their tax liabilities by about \$237 or more. On the other hand, we found no cases where tax filers claiming a Hope credit would have been better off by claiming a Lifetime Learning credit instead.

Suboptimal choices were not limited to tax filers who prepared their own tax returns. A possible indicator of the difficulty people face in understanding education-related tax preferences is how often the suboptimal choices we identified were found on tax returns prepared by paid tax preparers. We estimate that about 50 percent of the returns we found that appear to have failed to optimally reduce the tax filer's tax liability were prepared by paid tax preparers. Generalized to the population of tax returns we were able to review, returns prepared by paid tax preparers represent about 223,000 of the approximately 447,000 suboptimal choices we found.

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## The Suboptimal Use of Postsecondary Tax Preferences May Result from Their Complexity

The apparently suboptimal use of postsecondary tax preferences may arise, in part, because of the complexity of using these provisions. Tax policy analysts have frequently identified postsecondary tax preferences as a set of tax provisions that demand a particularly large investment of knowledge and skill on the part of students and families or expert

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<sup>19</sup>Our analysis considered the difference between (1) the 2002 maximum allowable Lifetime Learning credit, calculated from 20 percent of each tax filer's reported qualified educational expenses of up to \$5,000 and (2) the amount of possible deduction from income for qualified educational expenses of up to \$3,000 in combination with the tax filer's 2002 marginal tax rate.

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assistance purchased by those with the means to do so. They suggest that this complexity arises from multiple postsecondary tax preferences with similar purposes, from key definitions that vary across these provisions, and from rules that coordinate the use of multiple tax provisions. Additional complexity associated with the use of these provisions may arise from the interaction of tax preferences and title IV student aid. Complexity may lead some not to claim a credit because they judge the added costs of filing for the credit to outweigh its benefits.

## Multiple Tax Preferences

Multiple tax preferences with similar purposes may place substantial demands on the knowledge and skills of millions of students and families. Twelve tax preferences are outlined in the IRS publication, *Tax Benefits for Education*,<sup>20</sup> including four different tax preferences for educational saving.<sup>21</sup> Three of these preferences—Coverdell Education Savings Accounts, Qualified Tuition Programs, and U.S. education savings bonds—differ across more than a dozen dimensions, including the tax penalty that occurs when account balances are not used for qualified higher education expenses, who may be an eligible beneficiary, annual contribution limits, and other features.<sup>22</sup> Attempting to learn about, compare, and choose from among these tax-preferred higher education savings options may require substantial knowledge and skill on the part of parents with young dependents beyond that required of savings and investment decisions in general.

Among the tax preferences we reviewed, three help students meet current costs—the Hope credit, Lifetime Learning credit, and the tuition deduction. These tax preferences also differ across many dimensions.<sup>23</sup> Though similar in purpose, the three preferences have different eligibility criteria, benefit levels, and income-related phase-outs. For tax filers to obtain the maximum benefit from these preferences, they must first ascertain which

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<sup>20</sup> Department of Treasury, IRS Publication 970, *Tax Benefits for Education* (2004).

<sup>21</sup> The 12 programs and 2 others not listed in the Publication are listed in appendix III.

<sup>22</sup> Albert J. Davis, *Choice Complexity in Tax Benefits for Higher Education*, National Tax Journal, Vol. LV, No. 3 (September 2002).

<sup>23</sup> See, for example, U.S. Congress, Joint Committee on Taxation, *Present Law and Analysis Relating to Tax Benefits for Higher Education* (July 21, 2004); U.S. Congress, Joint Committee on Taxation, *Study of the Overall State of the Federal Tax System*, vol. II (April 2001).

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preference they are eligible to use,<sup>24</sup> and then correctly calculate which preference minimizes their tax liability by making separate calculations between the Hope and Lifetime Learning credits. If filers are within the phase-out range, they must calculate whether the tuition deduction is preferable to either credit. Tax filers with more than one student in postsecondary education may be eligible to claim multiple preferences, and may need to test different combinations of benefits to optimize tax savings.

### Varying Qualified Expense Definitions

Additional demands on the skill and knowledge of students and families may result from the fact that higher education tax preferences do not all use the same definition of qualified higher education expenses. What tax filers are allowed to claim as a qualified higher education expense varies, for example, between tax-exempt savings vehicles and tax credits. For example, while Coverdell Education Savings Accounts and section 529 Qualified Tuition Programs permit tax filers to include tuition, fees, books, supplies, and equipment required for enrollment as part of their qualified educational expenses, higher education tax credits permit only tuition and fees required for enrollment to be counted as qualified higher education expenses.<sup>25</sup> These dissimilar definitions require that tax filers keep track of expenses separately, applying some expenses to some tax preferences, but not others, and the Joint Committee on Taxation has suggested that they may increase the likelihood of inadvertent errors and may also increase taxpayer frustration.<sup>26</sup>

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### Tax Rules Coordinating the Use of Multiple Preferences

In addition to learning about, comparing, and selecting tax preferences, filers who wish to make optimal use of multiple tax preferences must understand how the use of one tax preference affects the use of others. The use of multiple education-related tax preferences is coordinated through rules that prohibit the application of the same qualified higher education expenses for the same student to more than one education-related tax preference, sometimes referred to as “anti-double-dipping rules.” These rules are important because they prevent tax filers from underreporting

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<sup>24</sup> Credit eligibility depends, in part, upon the academic year in which the student is enrolled, the number of credits taken by the student, the student’s status with respect to a degree or certificate program, and the adjusted gross income of the parents.

<sup>25</sup> Fees and expenses are qualified only if they must be paid to the institution as a condition of enrollment or attendance.

<sup>26</sup> *Study of the Overall State of the Federal Tax System*, vol. II, 125-6.

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their tax liability. Nonetheless, anti-double-dipping rules are potentially difficult for tax filers to understand and apply, and misunderstanding them may have consequences for a filer's tax liability.

Consider, for example, how the use of college savings programs and the tuition deduction is affected by these rules. To calculate whether a distribution from a college savings program is taxable, a tax filer must determine if the total distributions for the tax year are more or less than the total qualified educational expenses reduced by any tax-free educational assistance, i.e., their adjusted qualified education expenses (AQEE). After subtracting tax-free assistance from qualified educational expenses to arrive at the AQEE, tax filers multiply total distributed earnings by the fraction (AQEE / total amount distributed during the year). If parents of a dependent student paid \$6,500 in qualified education expenses from a \$3,000 tax-free scholarship and a \$3,600 distribution from a tuition savings program, they would have \$3,500 in AQEE. If \$1,200 of the distribution consisted of earnings, then  $\$1,200 \times (\$3,500 \text{ AQEE} / \$3,600 \text{ distribution})$  would result in \$1,167 of the earnings being tax-free, while \$33 would be taxable. However, if the same tax filer had also claimed a tuition deduction, anti-double-dipping rules would require the tax filer to subtract the expenses taken into account in figuring the tuition deduction from AQEE. If \$2,000 in expenses had been used toward the tuition deduction, then the taxable distribution from the section 529 savings program would rise to \$700.<sup>27</sup> For families such as these, anti-double-dipping rules increase the computational complexity they face and may result in unanticipated tax liabilities associated with the use of section 529 savings programs.

## Interaction between Tax Preferences and Student Financial Aid

Because the use of federal higher education tax preferences may affect a student's eligibility for title IV federal student assistance—and the receipt of title IV federal student assistance may affect a student's ability to use federal higher education tax preferences—many students and families must develop knowledge and skill sufficient to understand the relationship between the two. For example, the Internal Revenue Code requires tax filers to reduce the qualified higher education expenses they apply toward higher education tax credits by the amount of nontaxable aid they receive, including federal aid such as a Pell Grant. As a result, receiving a Pell Grant has the potential to reduce the amount of Hope or Lifetime Learning tax credit for which a filer is eligible. More generally, tax filers must take

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<sup>27</sup> The new nontaxable distribution figure is calculated  $\$1,200 \times (\$1,500 / \$3,600) = \$500$ . The taxable portion then becomes  $\$1,200 - \$500 = \$700$ .

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care to reduce their qualified higher education expenses by the amount of all nontaxable assistance that they receive—federal and nonfederal—applying only *adjusted* qualified higher education expenses toward credits, deductions, and distributions from tax-exempt savings vehicles.

While some federal higher education tax preferences, such as tax credits, have no effect on one's eligibility for title IV federal student assistance,<sup>28</sup> others do: like other family savings, assets held in tax-exempt savings vehicles, such as a Coverdell Education Savings Account or a section 529 savings account, are included in the calculation of the expected family contribution. In those instances where students are on the margin of eligibility to participate in need-based title IV federal aid programs, using these accounts may reduce the aid for which a student is eligible.

The federal financial aid methodology in place prior to January 2004 treated assets held in different savings vehicles in widely varying ways. According to one set of calculations, each dollar of funds held in a 529 savings program resulted in a reduction of 15 cents in need-based aid, while each dollar of funds held in a Coverdell Educational Savings Account resulted in a \$1.22 reduction in need-based aid.<sup>29</sup> For families close to the income limit for eligibility for need-based aid, a \$1,000 pretax investment in a Coverdell Educational Savings Account yielded a simulated final return (net of income taxation and foregone student aid) of -\$1,194, leaving the family worse off than if they had not saved, or if they had saved using a regular savings account (+\$490) or a traditional individual retirement account (+\$844). In response to recommendations contained in our 2002 report on student aid,<sup>30</sup> the Department of Education modified its guidance concerning federal financial aid methodology,<sup>31</sup> announcing that Coverdell assets would be treated as assets of the parent, rather than the student—

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<sup>28</sup> The Higher Education Act stipulates that the Hope and Lifetime Learning tax credits may not be considered either as estimated financial assistance in the assessment of aid eligibility, or as income or assets in the calculation of the expected family contribution.

<sup>29</sup> See Dynarski (2004). These calculations include school need-based grants and need-based federal aid (grant aid, work-study, and the Perkins and Stafford subsidized federal loans).

<sup>30</sup> GAO, *Student Aid and Tax Benefits: Better Research and Guidance Will Facilitate Comparison of Effectiveness and Student Use*, [GAO-02-751](#) (Washington, D.C.: Sept. 13, 2002).

<sup>31</sup> Department of Education, "Treatment of Coverdell Accounts and 529 Tuition Plans," Dear Colleague Letter, DCL ID: GEN-04-02 (posted Jan. 22, 2004).



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and, therefore, result in the same reduction in need-based aid as 529 savings program assets. Nonetheless, families that save in prepaid tuition programs remain subject to a dollar-for-dollar reduction in federal aid for each dollar distributed by the program.<sup>32</sup>

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## Research on Effectiveness of Federal Postsecondary Assistance Is Incomplete

Little is known about the effectiveness of federal grant and loan programs and education-related tax preferences in promoting attendance, choice, and persistence. Many federal aid programs and tax preferences have not been studied, and for those that have been studied, important aspects of their effectiveness remain unexamined. When research exists, it reaches varying conclusions about the effects of federal programs and tax preferences. Some studies identify no measurable effects on college attendance and persistence, while others find positive effects. (A bibliography listing the studies we reviewed is included at the end of this report.) Data and methodological challenges limit the certainty with which the effects of title IV programs and tax preferences, especially the effects of the latter, can be identified and result in widespread gaps in the knowledge of their effectiveness.<sup>33</sup> In 2002 we recommended that Education sponsor research into key aspects of effectiveness of title IV programs and that Education and the Department of the Treasury collaborate on such research into the relative effectiveness of title IV programs and tax preferences.<sup>34</sup> Since our prior report, little has been done to implement these recommendations, although Education is the process of establishing a postsecondary research center.

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<sup>32</sup> Dr. Susan Dynarski, testimony on “The Role of Higher Education Financing in Strengthening U.S. Competitiveness in a Global Economy” before the U.S. Congress, Senate Committee on Finance (July 22, 2004).

<sup>33</sup> We looked for studies addressing a program or tax preference’s affect on rates of postsecondary attendance, persistence, and choice because these measures have been the focus of congressional concern as expressed in committee reports, statutorily established study commissions, and requests for our work from Congress.

<sup>34</sup> GAO-02-751.

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**Little Is Known about the Effectiveness of Federal Title IV Postsecondary Programs and Tax Preferences**

We found no research on any aspect of effectiveness for several major title IV federal postsecondary programs and tax preferences, including the Federal Work-Study program, the tuition deduction, tax-exempt savings programs, and others. For other federal programs, no research exists on important aspects of program effectiveness. For example, no research has examined the effects of federal postsecondary education tax credits on students' persistence in their studies or on the type of postsecondary institution they choose to attend.

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**Limited Research about Federal Assistance Reaches Varying Conclusions about Some Aspects of Effectiveness**

When research on the effectiveness of federal assistance does exist, it reaches varying findings about title IV student aid and tax preferences. Some studies find that title IV programs increase the rates of college attendance and persistence, while others have identified no positive effects. Research on Pell Grants shows that they generally have little or no impact on attendance, with the exception of one study that found Pell Grants to have increased attendance for students from 22 to 35 years of age.<sup>35</sup> The study attributed the program's impact to the fact that older students generally attend less-expensive institutions where Pell Grants represent a larger share of the cost of college than the same size grants provided to students in general. The study also suggests that the limited impact of Pell Grants on attendance in general may be due to the fact that institutional aid awards may decrease at the same time as Pell Grant awards increase, creating a substitution effect that could diminish the impact of Pell Grants on attendance. According to the study, this occurs less often for older students because they tend to go to institutions that have less institutional aid for which Pell Grant awards might substitute.

Some research has also found that Pell Grants, like other grant programs, appear to increase students' persistence toward completing their studies.<sup>36</sup>

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<sup>35</sup> Hansen (1983), Kane (1995), and Kitmitto (2004) found that Pell Grants had little or no impact on attendance, while Seftor and Turner (2002) found they increased attendance for students of from 22 to 35 years of age.

<sup>36</sup> See Li (1999), Bettinger (2004), and Kitmitto (2004) for research on the impact of Pell Grants on persistence. Angrist (1993) and Bound and Turner (2002) found that the G.I. Bill and other veteran's benefits increased the amount of college completed. Dynarski (2003) found that the Social Security Student Benefit Program increased college completion as well. Dynarski (2004) found that merit aid increased college completion.

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Student loans have been found to modestly increase college attendance, persistence, and choice, but there are various limitations to consider. Of the three studies examining the effect of borrowing on college attendance, only one focuses on lower-income students.<sup>37</sup> The study estimates that a \$1,000 increase (in 1977 dollars) resulted in a 4.3 percentage point increase in college enrollment among dependent students with family incomes below \$15,000. However, given long-term changes in lending markets, returns to schooling, and other conditions, students' behavioral responses to equivalent changes in loan amounts may be different today from what they were in 1977.<sup>38</sup> Findings about the impact of loans on persistence and choice are each based on only one study, and focus only on middle-income students.<sup>39</sup>

We found one study concerning how the Hope and Lifetime Learning tax credits affect college attendance. The study found the credits to have no effect on college attendance. This may be because the students who receive these credits are likely to attend college anyway.<sup>40</sup> The author acknowledges several limitations of the study. For example, the study uses income categories—as opposed to actual income—thereby introducing measurement error and attenuating the estimated effects of the credits on attendance. We also note that the study measured eligibility for the credits, rather than the receipt of tax credits. Measuring eligibility rather than the receipt of credits tends to underestimate the effect of credits on attendance because many tax filers who appear to be eligible for the credits do not

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<sup>37</sup> See Reyes (1995), Dynarski (2002), and Long (2004), which focuses on low-income students.

<sup>38</sup> Likewise, because the composition of financial aid has changed—the frequency and levels of borrowing have increased—an equivalent (real) change in loan amounts may elicit a different response. In particular, some students, especially lower-income students, may already have large loan levels and be less willing to increase their loan debt than they were in 1977.

<sup>39</sup> See Reyes (1995) for estimates on how loans affect persistence and Dynarski (2002) for information on how loans affect college choice.

<sup>40</sup> See Long (2003b), which does not separately examine the Hope and the Lifetime Learning tax credits. A few additional papers have simulated the effect of the Hope tax credit on college attendance, including Cronin (1997) and Cameron and Heckman (1999). These estimates, however, are based on the findings of how students respond to other financial aid policies, which may be different from the response to these tax credits. In addition, Cronin (1997) bases her analysis on a proposed version of the tax credit as opposed to the enacted tax credit.

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claim them.<sup>41</sup> This study did not examine whether federal student tax credits affect persistence or choice.

In addition to the research into the federal tax, grant, and loan programs described above, a large body of research estimates the effects of both tuition changes and non-title IV financial aid programs on postsecondary attendance.<sup>42</sup> These studies all found either an inverse relationship between the cost of tuition and level of enrollment or that financial assistance increased enrollment.<sup>43</sup> One survey of this work concludes that a \$1,000 reduction in net costs (in 2001 dollars) would result in a 3 to 6 percent increase in college enrollment rates.<sup>44</sup> Federal Pell Grants and postsecondary tax credits do not show similar effects in the studies we examined. Substitution effects caused by offsetting reductions in nonfederal aid may diminish the enrollment effect of Pell awards. Also, the impact of tax credits on enrollment may be limited by the fact that tax filers receive higher education tax credits the year following tuition outlays. Program design and information may also account for some of these differences: tuition information and many nonfederal aid benefits are known when a person is choosing whether or not to attend college; however, students may not be aware of tax credits and Pell Grants or their effects on price until after they have already decided to go to college.

While federal grants, student loans, and tax credits were created to result in beneficial consequences, such as increasing college attendance, they have

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<sup>41</sup> Bershadker and Cronin (2004).

<sup>42</sup> There is also research on the effects of financial aid policy, in general, on choice. Linsenmeier, Rosen, and Rouse (2002) and Van Der Klaauw (2002) found that financial aid policy at specific schools positively affected the likelihood of whether accepted students chose to attend those schools. Avery and Hoxby (2003), focusing on high aptitude students, found that larger amount of grants, loans, and work-study made from all sources—federal, state, and institutions—were associated with students who were more likely to attend that school. Although it is unlike any existing federal program, Dynarski (2000) found that the Georgia Hope program shifted some would-be 2-year school students to 4-year schools and caused some students to choose to stay within state for college.

<sup>43</sup> See Leslie and Brinkman (1988), McPherson and Shapiro (1991), Rouse (1994), Kane (1995) and (1999), and Cameron and Heckman (1999) on the effects of tuition changes. See studies of the Georgia Hope Scholarship by Dynarski (2000) and Cornwell, Mustard, and Sridhar (2004) as well as those conducted by Bound and Turner (2002) on the G.I. Bill, by Dynarski (2003) on the Social Security Benefit Program, and by Kane (2003) on the Cal Grant Program.

<sup>44</sup> Kane (2002).

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also been found to result in the raising of tuition by institutions in some circumstances.<sup>45</sup> One potential explanation is that institutions raise tuition because federal aid increases the amount students are able to pay. Alternatively, federal aid may increase the demand for education, and with no offsetting factors, this drives the price of tuition up.

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## Data and Methodological Challenges Hinder Research

Gaps in the research-based evidence of federal postsecondary program effectiveness may be due, in part, to data and methodological challenges that have proven difficult to overcome. The relative newness of most of the tax preferences also presents challenges because relevant data are just now becoming available. Additionally, to analyze the tax programs, actual tax return data are preferred to indirect or processed data, but researchers are often limited to publicly available data containing self-reported information on income because of tax data confidentiality protections.

Methodological challenges add to the difficulty of estimating the effects of these programs. In general, researchers can reliably identify the behavioral effects of a program when one factor changes while all others remain unchanged. For example, if no other factors change, a researcher could identify the impact of postsecondary tax credits on enrollment by comparing enrollment rates before and after the tax credits are enacted. Typically, however, many factors change simultaneously, either offsetting or enhancing the effect of the policy intervention being studied. For example, tuition rates may rise at the same time that postsecondary tax credits are introduced, or other sources of postsecondary assistance—such as federal, state, or institutional grants—may decrease. These changes undermine researchers' ability to reliably isolate the behavioral effects of the policy under study. While researchers in some fields address this problem through the use of experiments, few opportunities exist for experimentation in the study of postsecondary education finance. Alternatively, researchers may address this problem through the use of quasi-experimental research designs, which attempt to approximate the random assignment of participants to treatment and control groups by matching participants to nonparticipants having similar characteristics. In practice, however, data limitations often make this difficult to implement. To isolate the impact of tax credits on college attendance, for example,

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<sup>45</sup> For studies of the effect on tuition, see Li (1999) for Pell Grants, Long (2003b) for tax credits, and Acosta (2001) for federal grant and federal loan aid. The Georgia Hope Scholarship has also been found to increase college costs by Long (2003a).

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researchers may need to compare credit recipients with nonrecipients who are similar in a range of ways—including academic preparation, family income and wealth. National surveys often do not contain complete data on all of these necessary factors both for those who attend and do not attend college.

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## Steps to Support Effectiveness Research

In 2002, we recommended that Education sponsor research into key aspects of effectiveness of title IV programs, and that Education and the Department of the Treasury collaborate on such research into the relative effectiveness of title IV programs and tax preferences.<sup>46</sup> In order to provide Congress with information about the effectiveness of title IV programs, we recommended in 2002 that Education sponsor research on the impact of title IV programs on postsecondary attendance, choice, completion, and costs. To provide information about the relative effectiveness of Education's direct expenditure programs and Treasury's postsecondary tax provisions, we recommended that the Secretaries of Education and Treasury collaborate in studying the combined effects of tax preferences and title IV aid. Few steps have been taken to implement these recommendations. However, Education is in the process of establishing a postsecondary research center that will, among other things, examine the impact of title IV programs.

As we noted in our 2002 report, research into the effectiveness of different forms of postsecondary education assistance is important. Without such information federal policymakers cannot make fact-based decisions about how to build on successful programs and make necessary changes to improve less effective programs. As we stress in our recent report

*21<sup>st</sup> Century Challenges: Reexamining the Base of the Federal Government*<sup>47</sup>, the budget deficit and other major fiscal challenges facing the nation necessitate rethinking the base of existing federal spending and tax programs, policies, and activities by reviewing their results and testing their continued relevance and relative priority for a changing society.

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<sup>46</sup> GAO, *Student Aid and Tax Benefits: Better Research and Guidance Will Facilitate Comparison of Effectiveness and Student Use*, [GAO-02-751](#) (Washington, D.C.: September 13, 2002).

<sup>47</sup> GAO, *21<sup>st</sup> Century Challenges: Reexamining the Base of the Federal Government*, [GAO-05-325SP](#) (Washington, D.C.: February 2005).

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In our January 2004 report on OMB's Program Assessment Rating Tool (PART),<sup>48</sup> we recommended that OMB target PART assessments based on such factors as the relative priorities, costs, and risks associated with related clusters of programs and activities and that OMB select related or similar programs for review in the same year to facilitate comparisons and trade-offs.<sup>49</sup> Furthermore, in our June 14, 2005 testimony before the Senate Committee on Homeland Security and Governmental Affairs, Subcommittee on Federal Financial Management, Government Information, and International Security, we reported that it is often critical to understand how programs fit with a portfolio of tools and strategies in order to capture whether programs complement and support related programs, are duplicative or redundant, or work at cross purposes to other initiatives.<sup>50</sup> The different tax preferences and title IV programs in place to help students and families finance postsecondary education are a good example of the sort of related clusters of programs and activities to which we were referring.

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## Concluding Observations

Congress has adopted a range of tools to help students and families pay for postsecondary education, including grants, loans, and tax preferences. Many title IV financial aid programs have a long history, while most of the tax preferences do not. The addition of tax preferences to the title IV grant and loan programs has increased the number of options and given students and families new choices about how to combine saving, borrowing, and current income to meet the costs of postsecondary education. Postsecondary tax preferences are widely thought to present challenges of complexity to students and families. As we have shown, tax filers appear to have some difficulty in making fully effective use of some postsecondary

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<sup>48</sup> GAO, *Performance Budgeting: Observations on the Use of OMB's Program Assessment Rating Tool for the Fiscal Year 2004 Budget*, [GAO-04-174](#) (Washington, D.C.: January 30, 2004).

<sup>49</sup> OMB describes the PART as a diagnostic tool meant to provide a consistent approach to evaluating federal programs as part of the executive budget formulation process. It applies 25 questions under four broad topics: (1) program purpose and design, (2) strategic planning, (3) program management, and (4) program results. It also uses additional questions specific to the mechanism or approach used to deliver the program, such as grants or credit programs (e.g. student loans). OMB has not systematically applied the PART to tax preferences.

<sup>50</sup> *21<sup>st</sup> Century Challenges: Performance Budgeting Could Help Promote Necessary Reexamination*, [GAO-05-709T](#) (Washington D.C.: June 14, 2005).

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tax preferences now in the tax code. Also, although millions of tax filers are receiving billions of dollars in assistance with postsecondary costs through both title IV programs and tax preferences, little is known about the effectiveness of any of these forms of assistance in part because of data and methodological issues. As we recommended in our 2002 report on federal financial aid,<sup>51</sup> it is important that information about the effectiveness of both tax preferences and title IV federal grant and loan programs be developed so that decision makers in Congress and in the executive branch can make efficient use of limited federal resources and reexamine, if necessary, the tools used to help students and families pay for postsecondary education.

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## Agency Comments and Our Evaluation

We provided a draft of this report to the Internal Revenue Service, the Department of the Treasury, and the Department of Education for review and comment. The Internal Revenue Service provided technical comments, which we incorporated. The Department of the Treasury did not provide comments on our report.

In its written comments, Education disagreed with our conclusion on the extent that title IV programs have been studied. Education also said that we did not properly acknowledge the role that its National Postsecondary Student Aid Study (NPSAS) played in our analysis and that the report did not cite many Departmental publications prepared on the basis of NPSAS and other Departmental data collections, such as *Persistence and*

*Attainment of Beginning Students with Pell Grants.*<sup>52</sup> In our report, we describe NPSAS as a comprehensive study examining how students and their families pay for postsecondary education and note that we relied upon NPSAS data to conduct our analysis. Further, we explain in our report that our findings about the effectiveness of federal postsecondary assistance are based upon studies that meet professional standards of econometric analysis and contain acceptably identified statistical estimates

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<sup>51</sup> GAO-02-751.

<sup>52</sup> Wei, C.C., and Horn, L., *Persistence and Attainment of Beginning Students with Pell Grants*, NCES 2002-169, U.S. Department of Education, National Center for Education Statistics (Washington, D.C.: May 2002).



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of program effects. We do not include publications that fail to meet these standards. While the data collections cited by the Department provide useful descriptive information concerning title IV programs, they do not provide data sufficient to determine key program effects. In particular, because these data collections do not contain information about those who do not attend postsecondary institutions, they are of limited use in establishing the effectiveness of title IV programs, especially with respect to postsecondary attendance—a challenge we note in our report. Consequently, publications based upon these data share this limitation.

With respect to the study specifically cited by the Department—*Persistence and Attainment of Beginning Students with Pell Grants*—it does not contain acceptably identified estimates of Pell Grant effects on persistence. In particular, the study does not implement a design and include variables that can isolate the effect of Pell Grant receipt on persistence from other factors that are associated both with persistence and with Pell Grant receipt, including academic preparation, changes in family income, and the net cost of education. Thus the study’s estimate of the effect of Pell Grants on persistence may reflect not only the influence of the Pell Grant, but also the influence of these other factors. Consequently, its results cannot be used to reliably assess the impact of Pell Grant receipt on persistence.<sup>53</sup>

Although Education stated that our report presented an incomplete and inaccurate assessment of its research, it nonetheless agreed that more research should be done and that it is “committed to continuing to increase its research associated with the effectiveness of the [its] programs.” The Department expressed a similar commitment in response to our September 2002 report<sup>54</sup> which found that Education had undertaken little work identifying the impact of its grant and loan programs and recommended that the Department sponsor research on the impact of title IV programs on postsecondary education attendance and choice, completion, and costs.

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<sup>53</sup> A similar conclusion is reached in *Review of NCES Research on Financial Aid and College Participation and Omitted Variables and Sample Selection Issues in the NCES Research on Financial Aid and College Participation*, Reports Prepared for the Advisory Committee on Student Financial Assistance by Donald E. Heller and William E. Becker (September 2003).

<sup>54</sup> GAO, *Student Aid and Tax Benefits: Better Research and Guidance Will Facilitate Comparison of Effectiveness and Student Use*, [GAO-02-751](#) (Washington, D.C.: Sept. 13, 2002).

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As agreed with your offices, unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days after its date. At that time, we will send copies of this report to The Commissioner of Internal Revenue, The Secretary of Education, The Secretary of the Treasury, and other interested parties. This report is available at no charge on GAO's web site at <http://www.gao.gov>.

If you or any of your staff have any questions, please contact Michael Brostek at (202) 512-9110 or Cornelia Ashby at (202) 512-7215. You may also reach us by e-mail at [BrostekM@gao.gov](mailto:BrostekM@gao.gov) and [AshbyC@gao.gov](mailto:AshbyC@gao.gov). Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. Key contributors to this report were David Lewis, Assistant Director, Jeff Appel, Assistant Director, Eric Mader, Thomas Weko, John Mingus, Cynthia Decker, Jeffrey Weinstein, and Katherine France.



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# Objectives, Scope, and Methodology

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Our review focused on answering the following three questions: (1) How does title IV grant and loan assistance compare with that provided through the tax code? (2) To what extent are tax filers effectively using the opportunities presented by postsecondary tax preferences? (3) What is known about the effectiveness of federal assistance in promoting college attendance, providing students with a wider range of choices among postsecondary institutions, or encouraging students to persist in their studies?

To compare title IV programs and tax preferences, we reviewed articles, studies, and reports on federal assistance for postsecondary education published by the Joint Committee on Taxation, the Internal Revenue Service (IRS), the Department of Education's National Center for Education Statistics and Office of Federal Student Aid, and other sources. Programs or tax preferences that served more than 500,000 participants were judged to be, for the purpose of our review, major. To obtain information on participant numbers and other comparative information, we used (1) fiscal year 2004 information from the President's fiscal year 2006 budget request,<sup>1</sup> (2) IRS's 2002 Statistics of Income (SOI) data set including IRS Form 1098-T information for all tax filers in the 2002 SOI sample, (3) 2003-2004 school year data from the National Postsecondary Student Aid Study (NPSAS),<sup>2</sup> (4) data as of December 31, 2004, on the number of accounts and amounts invested in section 529 Qualified Tuition Programs from the College Savings Plans Network,<sup>3</sup> and (5) tax year 2002 data on the estimated number of contributions to Coverdell Education Savings Accounts from IRS. We also reviewed studies conducted by Congressional Research Service, the Congressional Budget Office, GAO, the Department of the Treasury, the Urban Institute, and the College Board. We also interviewed individuals from the Congressional Research Service, Education, IRS, Treasury, and universities.

The 2002 SOI data and 2003-2004 NPSAS data were the most recent data available. The SOI individual tax return file is a stratified probability

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<sup>1</sup> Office of Management and Budget, *Appendix, Budget of the United States Government, Fiscal Year 2006* (Washington, D.C.: Feb 7, 2005).

<sup>2</sup> The NPSAS school year begins July 1 and ends on June 30 of the following year.

<sup>3</sup> The College Savings Plan Network collects information from the states about the numbers of 529 accounts. The data are voluntarily provided by the states. On the basis of our interview with College Savings Plan Network staff, we determined that these data were sufficiently reliable for our use in this study.

sample of income tax returns filed with IRS. The SOI sample of 175,000 returns represented the approximately 130 million tax returns filed for 2002. NPSAS is a comprehensive study that examines how students and their families pay for postsecondary education. It includes nationally representative samples of 79,852 undergraduates, 9,611 graduate students, and 1,283 first-professional students enrolled during the 2003-2004 academic year. The NPSAS data are based on student interviews and administrative records, and NPSAS includes survey results from both students who received financial aid and those who did not. To assess the reliability of the SOI and NPSAS sample data, we reviewed existing information about the samples and performed electronic testing of the required data elements to detect obvious problems in accuracy and completeness. We determined that SOI and NPSAS data, as well as other data used to provide certain specific pieces of information, were sufficiently reliable for this report.

Because estimates from the SOI and NPSAS data are based on samples, they are subject to sampling errors. These sampling errors measure the extent to which the point estimates may vary from the actual values in the population of tax filers. Each of our estimates is surrounded by a 95 percent confidence interval: an interval that 95 times out of 100 will contain the true population value. The upper and lower bounds of the 95 percent confidence intervals for each estimate are presented in the tables in appendix II.

To examine the extent to which tax filers are effectively using postsecondary education tax preferences, we used much of the same information we obtained for the description and comparison of the programs and tax preferences. In addition we estimated the number of tax filers who were eligible for an education tax credit or tuition and fees deduction but either did not claim one at all or appeared to make a less-than-optimal choice among these tax preferences and the amounts of tax benefits lost as a result. To do this analysis we used IRS's SOI sample of individual tax returns for tax year 2002 and all Form 1098-T information returns for tax filers in the sample. Postsecondary institutions participating in Education's student aid programs are required to issue Form 1098-Ts to all enrolled students. Form 1098-Ts include the student's name, address, and social security number, and the school's taxpayer identification number (TIN). Form 1098-Ts also indicate if the student was a graduate student and if he or she was enrolled at least half-time. Postsecondary institutions had the option of providing information concerning students' educational expenses, scholarships, and grants but were not required to do

so. By combining information on the Form 1098-Ts with information on the tax return, we were able to identify the postsecondary student population in the SOI sample and the choices that tax filers made concerning education-related tax preferences.

To conduct the analysis, we had to exclude two types of tax returns from consideration. Because a person cannot claim the tuition deduction or the Hope or Lifetime Learning credits if he or she is claimed as a dependent on someone else's tax return, we excluded dependent tax returns in the SOI sample from our analysis. We also excluded the tax returns of tax filers that received a Form 1098-T with no information concerning students' educational expenses because we could not analyze the tax returns without these data. This included the tax returns of individuals who received an education tax credit or tuition deduction but did not receive a Form 1098-T. These limitations excluded 87 percent of the returns in the sample.

We considered different explanations for why those tax filers with education expenses did not claim an education tax credit or tuition deduction. For example, we examined whether tax filers had (1) income that exceeded the program thresholds for tax year 2002, (2) no taxable income, (3) no tax liability after claiming other tax credits, or (4) no net educational expenses after accounting for scholarships and grants as reported on the Form 1098-T. We also examined whether tax filers were married filing separately or filed a Form 1040EZ because this would prevent tax filers from being able to claim the education tax credits or tuition deduction.

We calculated tax filers' optimal choice among the Hope and Lifetime Learning credits, and the tuition deduction on the basis of program eligibility criteria for tax year 2002. Tax filers are limited to claiming either a tuition deduction or an education tax credit for the same student. Eligibility is restricted by modified adjusted gross income and, in the case of the Hope tax credit, whether or not students are enrolled at least half-time.

We shared our methodology for this analysis with tax policy researchers outside of GAO and incorporated their comments into our analysis.

To identify available academic research on the effectiveness of major federal financial aid programs, we reviewed studies that examined whether the programs or tax preferences affect college attendance, persistence, and choice. We looked for these measures because they have been the focus of

congressional concern as expressed in committee reports, statutorily established study commissions, and requests for our work from Congress. We examined studies we found through searches in EconLit, Digital Dissertations from ProQuest, and the National Bureau of Economic Research web site. These online sources are nationally recognized repositories of research results. In addition, we also examined relevant studies cited in studies found from our searches. Some of these studies were excluded from further assessment because they did not undertake original data analysis that could identify the effectiveness of federal financial aid programs. We assessed studies that provided an original empirical analysis according to professional standards of econometric analysis for their methodological rigor. The results of the studies that we judged to contain acceptably identified statistical estimates formed the basis for our findings about the availability of information concerning the relative effectiveness of major federal financial aid programs.

We conducted our review from May 2004 through June 2005 in accordance with generally accepted government auditing standards.

# Confidence Intervals

We used two data sets in this review: Education's 2003-2004 National Postsecondary Student Aid Study and the Internal Revenue Service's 2002 Statistics of Income. Estimates from both data sets are subject to sampling errors and the estimates we report are surrounded by a 95 percent confidence interval. The following tables provide the lower and upper bounds of the 95 percent confidence interval for all estimate figures in the tables in this report. For figures drawn from these data, we provide both point estimates and confidence intervals.

**Table 7: Description of Federal Student Aid Programs Authorized under Title IV of the Higher Education Act**

Type of assistance	Number of recipients		Total award		Average award		Median income	
	Lower bound	Upper bound	Lower bound	Upper bound	Lower bound	Upper bound	Lower bound	Upper bound
<b>Dependent students</b>								
Pell Grant	2,026,011	2,115,312	5,201,091,600	5,452,845,564	2,543	2,573	24,165	24,999
Supplemental Educational Opportunity Grant	530,408	577,316	466,079,305	522,325,472	857	892	22,022	23,484
Federal Work- Study	1,023,755	1,089,687	1,927,247,135	2,090,819,033	1,856	1,901	45,000	48,231
Federal Perkins Loan	472,640	517,207	907,800,538	1,004,290,295	1,887	1,932	37,623	40,814
Subsidized FFEL or Direct Stafford Loan	2,505,118	2,604,668	7,962,531,788	8,329,729,995	3,155	3,188	43,834	45,446
Unsubsidized FFEL or Direct Stafford Loan	1,578,160	1,664,757	5,173,481,648	5,505,576,910	3,244	3,293	74,263	77,439
FFEL or Direct PLUS Loan	609,125	659,071	5,458,550,634	5,979,275,038	8,787	9,019	69,547	73,439
<b>Independent students</b>								
Pell Grant	2,967,340	3,087,638	7,212,123,299	7,540,282,035	2,409	2,436	12,614	13,262
Supplemental Educational Opportunity Grant	684,528	745,839	368,492,546	415,343,758	526	548	10,425	11,626
Federal Work- Study	676,216	766,317	933,916,755	1,084,530,206	2,192	2,303	9,808	11,525
Federal Perkins Loan	522,918	595,499	839,749,704	970,851,318	2,648	2,752	9,181	11,628
Subsidized FFEL or Direct Stafford Loan	3,658,692	3,869,237	15,604,880,694	17,068,144,196	4,244	4,340	18,754	20,148
Unsubsidized FFEL or Direct Stafford Loan	3,154,948	3,359,231	17,728,962,613	19,212,909,259	5,531	5,671	21,190	23,095
FFEL or Direct PLUS Loan	0	0	0	0	0	0	0	0

Source: GAO analysis of 2003-2004 National Postsecondary Student Aid Study data.

**Appendix II  
Confidence Intervals**

**Table 8: Selected Postsecondary Education Tax Preferences**

Type of assistance	Number of returns		Total benefits		Average benefit		Median income	
	Lower bound	Upper bound	Lower bound	Upper bound	Lower bound	Upper bound	Lower bound	Upper bound
Hope Credit	3,115,595	3,414,023	3,064,601,005	3,399,426,275	965	1,016	37,506	41,004
Lifetime Learning Credit	3,307,354	3,612,179	1,560,825,683	1,740,857,453	462	493	38,060	41,001
Student Loan Interest Deduction	6,432,399	6,849,170	848,115,632	937,085,664	129	140	42,378	44,657
Tuition Deduction	3,295,741	3,599,012	1,226,452,349	1,370,953,823	364	391	51,808	56,842

Source: GAO analysis of Statistics of Income data for 2002.

**Table 9: Tax Filers Claiming an Education Tax Credit or Tuition Deduction**

		1998	1999	2000	2001	2002
Hope Credit, Lifetime Learning Credit, and Tuition Deduction	Lower bound	4,482,106	6,233,732	6,606,583	6,997,019	9,319,692
	Upper bound	4,827,719	6,639,576	7,024,049	7,428,088	9,809,833

Source: GAO analysis of Statistics of Income data for 2002.

**Table 10: Percentage of Aid Recipients and Dollars of Aid by Income Category for Dependent Students Served by Selected Title IV Programs**

Program	Dependent students		\$0-20,000	\$20,001-40,000	\$40,001-60,000	\$60,001-80,000	\$80,001-100,000	More than \$100,000
			Pell Grant	Recipients	Lower bound	36.66	45.41	13.17
		Upper bound	38.89	47.72	14.76	2.02	0	0
	Dollars	Lower bound	46.29	42.41	7.38	0.65	0	0
		Upper bound	48.82	44.89	8.5	1.04	0	0
Stafford Subsidized Loan	Recipients	Lower bound	15.41	26.79	22.45	16.1	8.38	6.23
		Upper bound	16.94	28.73	24.3	17.72	9.61	7.33
	Dollars	Lower bound	15.32	27.14	22.83	15.68	7.92	5.87
		Upper bound	17.07	29.35	24.94	17.51	9.3	7.08
Stafford Unsubsidized Loan	Recipients	Lower bound	6.51	12.83	13.15	17.69	16.68	27
		Upper bound	7.88	14.76	15.21	19.94	18.84	29.5
	Dollars	Lower bound	6.22	11.05	11.31	16.69	17.55	30.3
		Upper bound	7.75	12.99	13.41	19.2	20.15	33.37

Source: GAO analysis of 2003-2004 National Postsecondary Student Aid Study data.



**Appendix II  
Confidence Intervals**

**Table 11: Percentage of Aid Recipients and Dollars of Aid by Income Category for Independent Students Served by Selected Title IV Programs**

Program			\$0- 20,000	\$20,001- 40,000	\$40,001- 60,000	\$60,001- 80,000	\$80,001- 100,000	More than \$100,000
Pell Grant	Recipients	Lower bound	66.28	26.59	4.59	0	0	0
		Upper bound	68.35	28.57	5.62	0	0	0
	Dollars	Lower bound	71.68	23.62	2.32	0	0	0
		Upper bound	73.77	25.65	2.96	0	0	0
Stafford Subsidized Loan	Recipients	Lower bound	49.67	27.54	10.78	4.04	1.3	0.86
		Upper bound	52.62	30.38	13.48	5.36	1.98	2.38
	Dollars	Lower bound	49.93	25.26	10.05	3.87	1.2	0.46
		Upper bound	54.61	29.79	14.73	5.4	2.05	2.65
Stafford Unsubsidized Loan	Recipients	Lower bound	44.65	26.59	12.09	5.48	2.31	2.26
		Upper bound	47.82	29.75	15.18	6.87	3.18	4.08
	Dollars	Lower bound	44.28	22.51	11.96	6.22	2.86	3.42
		Upper bound	48.37	26	14.78	8.49	4.12	6.99

Source: GAO analysis of 2003-2004 National Postsecondary Student Aid Study data

**Table 12: Percentage of Tax Filers Claiming Hope and Lifetime Learning Credits and Tuition Deduction and Tax Preference Dollars by Income Category, Tax Year 2002**

Type of Aid			\$0-20,000	\$20,001- 40,000	\$40,001- 60,000	\$60,001- 80,000	\$80,001- 100,000	More than \$100,000
Hope Credit	Tax filers	Lower bound	16.63	30.43	18.06	16.2	9.45	0.1
		Upper bound	20.29	34.75	21.67	19.7	12.27	0.62
	Dollars	Lower bound	9.14	30.19	20.37	21.75	8.66	0
		Upper bound	11.82	35.06	24.77	26.52	11.7	0.03
Lifetime Learning Credit	Tax filers	Lower bound	14.59	32.04	23.06	14.74	6.73	0.14
		Upper bound	17.89	36.25	26.85	18.03	9.14	0.67
	Dollars	Lower bound	10.73	31.78	22.56	18.58	5.98	0
		Upper bound	13.97	37.02	27.24	23.32	8.79	0.02
Tuition Deduction	Tax filers	Lower bound	18.38	16.56	14.81	11.03	14.08	15.23
		Upper bound	21.91	20.04	18.14	14.01	17.33	18.49
	Dollars	Lower bound	9.41	8.83	11.55	11.53	20.79	26.16
		Upper bound	11.93	11.63	15.1	15.52	25.91	31.65

Source: GAO analysis of Statistics of Income data for 2002.

**Appendix II**  
**Confidence Intervals**

**Table 13: Percentage of Form 1098-Ts with Postsecondary Expense Information in 2002: Point Estimates**

	Number of returns	Percent of returns
1098Ts with expense information	1,795,180	13
1098Ts without expense information	12,356,444	87

Source: GAO analysis of Statistics of Income data for 2002.

**Table 14: Percentage of Form 1098-Ts with Postsecondary Expense Information in 2002: Confidence Intervals**

	Number of returns: Lower bound	Number of returns: Upper bound	Percent of returns: Lower bound	Percent of returns: Upper bound
1098Ts with expense information	1,687,744.88	1,902,614.62	11.97	13.4
1098Ts without expense information	12,087,410.46	12,625,476.86	86.6	88.03

Source: GAO analysis of Statistics of Income data for 2002.

**Table 15: Percentage of Taxpayers Apparently Eligible to Claim an Education Tax Credit or Tuition Deduction in 2002: Point Estimates**

	Number of returns	Percent of returns
Total	1,795,180	100
Potentially eligible	1,386,659	77
All Other	408,521	23

Source: GAO analysis of Statistics of Income data for 2002.

**Table 16: Percentage of Taxpayers Apparently Eligible to Claim an Education Tax Credit or Tuition Deduction in 2002: Confidence Intervals**

	Number of Returns: Lower bound	Number of returns: Upper bound	Percent of returns: Lower bound	Percent of returns: Upper bound
Total	1,795,176.75	1,795,179.75	100	100
Potentially eligible	1,290,394.34	1,482,923.26	74.83	79.66
All other	360,292.26	456,749.64	20.34	25.17

Source: GAO analysis of Statistics of Income data for 2002.

**Appendix II  
Confidence Intervals**

**Table 17: Percentage of Apparently Eligible Taxpayers to Claim an Education Tax Credit or Tuition Deduction That Failed to Do So in 2002: Point Estimates**

	Number of returns	Percent of returns
Failed to claim	373,595	27

Source: GAO analysis of Statistics of Income data for 2002.

**Table 18: Percentage of Apparently Eligible Taxpayers to Claim an Education Tax Credit or Tuition Deduction That Failed to Do So in 2002: Confidence Intervals**

	Number of returns: Lower bound	Number of returns: Upper bound	Percent of returns: Lower bound	Percent of returns: Upper bound
Failed to claim	323,504.26	423,686.08	23.85	30.04

Source: GAO analysis of Statistics of Income data for 2002.

**Table 19: Amounts by Which Apparently Eligible Taxpayers Failed to Reduce Their Tax Liability: Point Estimates**

	Inaction led to increased tax liability
Median	52.45
Mean	168.66
10 <sup>th</sup> percentile	4.34
25 <sup>th</sup> percentile	10.94
75 <sup>th</sup> percentile	207.2
90 <sup>th</sup> percentile	532.96
Maximum value	1,116

Source: GAO analysis of Statistics of Income data for 2002.

**Appendix II  
Confidence Intervals**

**Table 20: Amounts by Which Apparently Eligible Taxpayers Failed to Reduce Their Tax Liability: Confidence Intervals**

	<b>Inaction led to increased tax liability</b>
Median: Lower bound	34.69
Median: Upper bound	73.57
Mean: Lower bound	136.57
Mean: Upper bound	200.76
10th percentile: Lower bound	3.01
10th percentile: Upper bound	6.57
25th percentile: Lower bound	8.66
25th percentile: Upper bound	16.72
75th percentile: Lower bound	137.73
75th percentile: Upper bound	312.14
90th percentile: Lower bound	429.22
90th percentile: Upper bound	729.58

Source: GAO analysis of Statistics of Income data for 2002.

**Table 21: Percentage of Apparently Eligible Taxpayers That Claimed the Tuition Deduction but Would Have Been Better off Claiming the Lifetime Learning Credit in 2002: Point Estimates**

	<b>Number of returns</b>	<b>Percent of returns</b>
Would have been better off claiming Lifetime Learning Credit	50,908	21

Source: GAO analysis of Statistics of Income data for 2002.

**Table 22: Percentage of Apparently Eligible Taxpayers That Claimed the Tuition Deduction but Would Have Been Better off Claiming the Lifetime Learning Credit in 2002: Confidence Intervals**

	<b>Number of Returns: Lower bound</b>	<b>Number of returns: Upper bound</b>	<b>Percent of returns: Lower bound</b>	<b>Percent of returns: Upper bound</b>
Would have been better off claiming Lifetime Learning Credit	34,819.89	70,274.77	14.53	29.33

Source: GAO analysis of Statistics of Income data for 2002.

**Table 23: Amounts by Which Apparently Eligible Taxpayers Could Have Reduced Their Tax Liability in 2002: Point Estimates**

	<b>Lifetime Learning Credit produced larger reduction</b>
Median	50.67
Mean	83.22
10 <sup>th</sup> percentile	7.35
25 <sup>th</sup> percentile	26.23
75 <sup>th</sup> percentile	119.6
90 <sup>th</sup> percentile	157.91
Maximum value	556

Source: GAO analysis of Statistics of Income data for 2002.

**Table 24: Amounts by Which Apparently Eligible Taxpayers Could Have Reduced Their Tax Liability in 2002: Confidence Intervals**

	<b>Lifetime Learning Credit produced larger reduction</b>
Median: Lower bound	32.89
Median: Upper bound	84.27
Mean: Lower bound	49.76
Mean: Upper bound	116.68
10th percentile: Lower bound	.
10th percentile: Upper bound	27.14
25th percentile: Lower bound	10.7
25th percentile: Upper bound	47.56
75th percentile: Lower bound	62.07
75th percentile: Upper bound	148.53
90th percentile: Lower bound	106.35
90th percentile: Upper bound	.

Source: GAO analysis of Statistics of Income data for 2002.

**Appendix II  
Confidence Intervals**

**Table 25: Percentage of Apparently Eligible Taxpayers That Claimed the Lifetime Learning Credit but Would Have Been Better off Claiming the Tuition Deduction in 2002: Point Estimates**

	Number of returns	Percent of returns
Would have been better off claiming the Tuition Deduction	22,469	8

Source: GAO analysis of Statistics of Income data for 2002.

**Table 26: Percentage of Apparently Eligible Taxpayers That Claimed the Lifetime Learning Credit but Would Have Been Better off Claiming the Tuition Deduction in 2002: Confidence Intervals**

	Number of Returns: Lower bound	Number of returns: Upper bound	Percent of returns: Lower bound	Percent of returns: Upper bound
Would have been better off claiming the Tuition Deduction	12,228.08	37,165.3	4.48	13.61

Source: GAO analysis of Statistics of Income data for 2002.

**Table 27: Amounts by Which Apparently Eligible Taxpayers Could Have Reduced Their Tax Liability in 2002: Point Estimates**

	Tuition Deduction produced larger reduction
Median	108.05
Mean	137.68
10 <sup>th</sup> percentile	17.3
25 <sup>th</sup> percentile	36.42
75 <sup>th</sup> percentile	191.55
90 <sup>th</sup> percentile	237.42
Maximum value	456

Source: GAO analysis of Statistics of Income data for 2002.

**Table 28: Amounts by Which Apparently Eligible Taxpayers Could Have Reduced Their Tax Liability in 2002: Confidence Intervals**

	<b>Deduction produced larger reduction</b>
Median: Lower bound	37.39
Median: Upper bound	190.77
Mean: Lower bound	77.08
Mean: Upper bound	198.28
10th percentile: Lower bound	4.36
10th percentile: Upper bound	41.46
25th percentile: Lower bound	20.16
25th percentile: Upper bound	108.84
75th percentile: Lower bound	107.3
75th percentile: Upper bound	244.85
90th percentile: Lower bound	154.73
90th percentile: Upper bound	350.13

Source: GAO analysis of Statistics of Income data for 2002.

**Table 29: Percentage of Apparently Eligible Taxpayers That Claimed a Hope Credit but Would Have Been Better off Claiming a Lifetime Learning Credit in 2002: Point Estimates**

	<b>Number of returns</b>	<b>Percent of returns</b>
Total	271,494	100
Would have been better off claiming Lifetime Learning Credit	0	0
All other	271,494	100

Source: GAO analysis of Statistics of Income data for 2002.

**Appendix II  
Confidence Intervals**

**Table 30: Percentage of Apparently Eligible Taxpayers That Claimed a Hope Credit but Would Have Been Better off Claiming a Lifetime Learning Credit in 2002: Confidence Intervals**

	Number of Returns: Lower bound	Number of returns: Upper bound	Percent of returns: Lower bound	Percent of returns: Upper bound
Total	271,491.04	271,494.04	100	100
Would have been better off claiming Lifetime Learning Credit	0	0	0	0
All other	271,491.04	271,494.04	100	100

Source: GAO analysis of Statistics of Income data for 2002.

**Table 31: Percentage of Suboptimal Choices Made by Paid Tax Preparers: Point Estimates**

	Taxpayers making suboptimal choice	
	Number of returns	Percent
Total	446,972	100
No preparer	219,139	49.03
Paid preparer	223,011	49.89
IRS prepared/reviewed	0	0
VITA/self help/outreach/elderly assistance	4,822	1.08

Source: GAO analysis of Statistics of Income data for 2002.

**Table 32: Percentage of Suboptimal Choices Made by Paid Tax Preparers: Confidence Intervals**

	Taxpayers Making Suboptimal choice			
	Number of returns: Lower bound	Number of returns: Upper bound	Percent: Lower bound	Percent: Lower bound
Total	392,039	501,905	99.72	100
No preparer	179,777	258,500	42.87	55.19
Paid preparer	184,952	261,070	43.74	56.05
IRS prepared/reviewed	0	0	0	0.28
VITA/self help/outreach/elderly assistance	1,131	9,328	0.26	2.91

Source: GAO analysis of Statistics of Income data for 2002.



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# Postsecondary-Education-Related Tax Preferences

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We analyzed the following postsecondary-education-related tax preferences in detail in this review.

**Lifetime Learning Credit:** Income-based tax credit claimed by tax filer on behalf of students enrolled in one or more postsecondary education courses.

**Hope Credit:** Income-based tax credit claimed by tax filer on behalf of students enrolled at least half-time in an eligible program of study and who are in their first 2 years of postsecondary education.

**Student Loan Interest Deduction:** Income-based tax deduction claimed by tax filer on behalf of students who took out qualified student loans while enrolled at least half time.

**Tuition and Fees Deduction:** Income-based tax deduction claimed by tax filer on behalf of students who are enrolled in one or more postsecondary education course and have either a high school diploma or a General Educational Development (GED) credential.

**Section 529 Qualified Tuition Programs—College Savings Programs and Prepaid Tuition Programs:** Non-income-based programs that provide favorable tax treatment to investments and distributions used to pay the expenses of future or current postsecondary students.

**Coverdell Education Savings Accounts:** Income-based savings program providing favorable tax treatment to investments and distributions used to pay the expenses of future or current elementary, secondary, or postsecondary students.

The following postsecondary-education-related tax preferences were not included in this review.

**Scholarships, Fellowships, Grants, and Tuition Reductions Income Exclusion:** Scholarships and fellowships paid directly to degree-candidate students or to their educational institutions for tuition and fees are not taxed as income. However, scholarships and fellowships covering room and board or transportation or paid in return for services, such as teaching, are taxable. Also, tuition reductions, for example discounts given to employees of an educational institution or their children, are not counted as income for tax purposes.

**Employer-Provided Education Benefits Exclusion:** Financial assistance provided by employers to employees up to \$5,250 in 2004 to pay for employee educational expenses is not counted as income for tax purposes. Only funds used to pay for tuition, fees, books, equipment, and similar expenses qualify. Funds from an employer and used to pay for meals, lodging, or transportation count as income for tax purposes.<sup>1</sup>

**Student Loan Forgiveness Exclusion:** Student loan repayment assistance or cancellation provided in exchange for working for a period of time in certain professions for any of a broad class of employers is not treated as taxable income.

**Education Savings Bonds:** Interest earned on U.S. savings bonds is not taxed if the bond holder is paying postsecondary education tuition and fees or making contributions to a 529 qualified tuition program or a Coverdell education savings account. The exclusion is available to tax filers with modified adjusted gross incomes below \$74,850 (\$119,750 if married filing jointly or qualified widow(er)).

**Business Expense Deduction of Work-Related Education:** Tax filers may deduct the cost of work-related education if the education is required by their employer or the law to maintain the tax filer's present salary, status, or job and maintains or improves skills needed in the tax filer's present work. Education to meet the minimum educational requirements of the tax filer's present trade or business or education towards a new trade or business does not qualify. The tax filer must itemize deductions on form 1040 Schedule A, C, or F. The amount of the deduction is the total of work-related education expenses plus other job and certain miscellaneous expenses that is in excess of 2 percent of adjusted gross income.

**Uniform Transfers to Minors:** Money paid directly to an educational institution for another person's tuition are not subject to gift taxes.<sup>2</sup>

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<sup>1</sup> Under the Working Condition Fringe Benefit Exclusion, employer-provided educational assistance that exceeds \$5,250 may still not be counted as income, provided it is used to pay for any educational expenses that are required by the employer or the law to maintain the tax filer's present salary, status, or job and maintain or improve skills needed in the tax filer's present work.

<sup>2</sup> This tax preference is not listed in the 2004 IRS Publication 970.

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**Early Withdrawals From Individual Retirement Accounts:** The 10 percent additional tax that applies to withdrawal of funds from an Individual Retirement Account does not apply if the funds are used to pay for the postsecondary education expenses of the account holder or his or her dependent.

**Parental Personal Exemption for Dependent Students:** The tax code definition of “dependent” for tax filing purposes involves 5 tests, including whether the dependent is (1) a member of your household or related to you, (2) a U.S. citizen or resident, (3) filing a joint tax return, (4) earning less than \$3,100, and (5) receiving more than half of their support from the taxpayer claiming the dependent. In 2004, someone over age 18, earning more than \$3,100, and not living with the tax filer throughout the year would likely not qualify as a dependent. However, the tax code makes exceptions to these rules for students under age 24, thus postsecondary education students are still dependents for tax purposes while they are in school.<sup>3</sup>

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<sup>3</sup>Ibid.

# Comments from the Department of Education



UNITED STATES DEPARTMENT OF EDUCATION

OFFICE OF POSTSECONDARY EDUCATION

THE ASSISTANT SECRETARY

JUL 12 2005

Cornelia M. Ashby  
Director, Education, Workforce,  
and Income Security Issues  
United States Government Accountability Office  
Washington, DC 20548

Dear Ms. Ashby:

Thank you for the opportunity to review and comment on your draft report, *Student Aid and Postsecondary Tax Preferences: Limited Research Exists on the Effectiveness of Tools to Assist Students and Families Through Title IV Student Aid and Tax Preferences (GAO-05-684)*.

While we agree with your assessment that more research should be done on various Federal programs that assist students enrolled in postsecondary education, we disagree with your conclusions that the Title IV programs, in particular, have not been adequately studied.

The report ignores the fact that the Government Accountability Office's (GAO) analysis of the Federal Student Aid (FSA) program could not have been conducted if the U.S. Department of Education's (Department) National Center for Education Statistics (NCES) had not recently completed the 6<sup>th</sup> National Postsecondary Student Aid Study (NPSAS). It also fails to mention the nearly 60 reports and other publications NCES prepared using data from NPSAS, the Survey of Beginning Postsecondary Students Longitudinal Study, and the Baccalaureate and Beyond Student Survey, each repeated 4 times. The NCES prepared the publications based on these vital data sources about the FSA programs.

One NCES report not considered, *Persistence and Attainment of Beginning Students with Pell Grants* (NCES Number 2002169, Released May 7, 2002), concludes that, among all low- and middle-income beginning students who were enrolled at four-year institutions in 1995-96, no differences in three-year persistence rates were detected between Pell Grant recipients and non-recipients. The GAO draft report fails to cite this study.

As indicated in the draft report, the Department is committed to continuing to increase its research associated with the effectiveness of our programs. However, GAO's failure to acknowledge such an extensive body of research presents an incomplete and inaccurate assessment.

Sincerely,

A handwritten signature in black ink, appearing to read "Sally L. Stroup".

Sally L. Stroup

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*Our mission is to ensure equal access to education and to promote educational excellence throughout the Nation.*

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