

## COLLEGE SAVINGS INITIATIVE

# ENHANCING TAX CREDITS TO ENCOURAGE SAVING FOR HIGHER EDUCATION

## Advancing the American Opportunity Tax Credit and Reforming the Saver's Credit

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The federal tax system contains numerous credits, deductions, and incentives for individuals and families to build wealth and make goals like higher education more accessible and affordable. By May 2010, over 129 million American taxpayers filed federal income tax returns from the previous year, ninety-six million – or three-fourths – of which resulted in a federal refund. The average federal refund was \$2,887 for all taxpayers, and low- and moderate-income (LMI) families in particular tend to receive larger tax refunds relative to annual income. In short, tax credits and incentives represent one of the few touch points each year for LMI families to set aside money for wealth building and future aspirations, particularly for higher education.

For education savings in particular, the federal government allows tax-free growth and tax-free qualified withdrawals through 529 college savings plans, Coverdells, and other savings vehicles. Many states also offer tax-free distribution, tax deductions, and other incentives for saving in 529 plans. These incentives were created to help families keep pace with the rising cost of college education.

However, incentives such as tax-free growth and non-refundable tax credits carry little weight with LMI families who struggle the most with college affordability, since

many have little or no tax liability.<sup>1</sup> Furthermore, extensive research has demonstrated LMI students are less likely to enroll in college or complete degrees, despite decades of nominal increases in federal financial aid.<sup>2</sup>

Finally, a postsecondary credential is one of the most consistent predictors of upward economic mobility: only 16

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<sup>1</sup> TAX FILING STATISTICS RETRIEVED FROM IRS.GOV (2010). SOI TAX STATS – FILING SEASON WEEKLY REPORTS: REPORTS FOR FILING YEAR 2010 – TAX YEAR 2009: [HTTP://WWW.IRS.GOV/TAXSTATS/ARTICLE/0,,ID=184855,0.HTML](http://www.irs.gov/taxstats/article/0,,id=184855,0.html)

<sup>2</sup> HASKINS, HOLZER, AND LERMAN (2009).

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percent of Americans born in the bottom income quintile who earn a college degree stay at the bottom, compared to 45 percent of those without a college degree.<sup>3</sup> Moreover, an emerging body of research has found a relationship between savings and account ownership and important aspirational benefits such as high school graduation, college attendance and completion. Account ownership in particular, controlling for income and other factors, has a particularly strong relationship to college attendance.<sup>4</sup> Savings can provide financial benefits as well, in the form of long-term growth and earnings, in addition to the aspirational benefits listed above.

Better-targeted incentives – particularly via existing tax credits – could positively impact savings behaviors, as well as make higher education a more concrete possibility for LMI families in ways that simply increasing financial aid packages may not.

## Advancing the American Opportunity Tax Credit to College Savings Plans

The Hope and Lifetime Learning Tax Credits were created in the 1990s to increase access to postsecondary education, with benefits phasing out for individuals earning more than \$50,000 to \$60,000 annually and couples earning between \$100,000 to \$120,000. A student could claim the Hope Credit for expenses during the first two years of college, whereas there is no limit on the number of years one could claim the Lifetime Learning Credit (a tax filer cannot claim both in a single year). Unfortunately, the credits applied to tuition and fees, but not other school-related expenses such as room and board, transportation, and books and supplies. In addition, the tax credits are not refundable, leaving low- and moderate-income families without a tax liability ineligible to receive the benefit. Moreover, complexity and timing complicate the credit for those families that are

eligible. Families often wait up to a year-and-a-half to receive claimed funds, and a 2008 Government Accountability Office report indicated that, due to complexity, nearly one in four middle-class families eligible to receive a credit claimed less than the maximum to which they were entitled.<sup>5</sup>

In 2009, the American Recovery and Reinvestment Act (ARRA) created the American Opportunity Tax Credit (AOTC) – a temporary replacement for the Hope Credit.<sup>6</sup> ARRA increased the maximum Hope Credit from \$1,800 to \$2,500 (the maximum Lifetime Learning Credit is \$2,000), and allows the credit to be claimed for a maximum of four years of college instead of the previous limit of two years. The credit applies to course-related equipment, books and supplies as well. ARRA also made the Hope Credit partially refundable, allowing LMI families to receive a credit of up to \$1,000, or 40% of the maximum credit for those with a tax liability – potentially reaching an additional 3.8 million students.<sup>7</sup> According to the Obama Administration, the average AOTC was \$1,700 in 2009, which represented a 75% increase over the average Hope and Lifetime Learning Credits from the prior year. Two in five of those claiming the AOTC had Adjusted Gross Income below \$30,000.<sup>8</sup>

While the American Opportunity Tax Credit is a significant improvement over the Hope Credit, the partial refundability and timing of the credits remain problematic for LMI students and households. However, making the credit fully refundable and allowing families the option of claiming the AOTC (or a portion thereof) and depositing the credit into a 529 college savings plan when the child enters 8th grade would remedy both problems. Monies from the tax credits

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<sup>5</sup> BROSTEK, SCOTT (2008).

<sup>6</sup> THE OBAMA ADMINISTRATION PROPOSED MAKING THE AMERICAN OPPORTUNITY TAX CREDIT PERMANENT AS PART OF ITS FY 2011 BUDGET.

<sup>7</sup> HUANG, ET AL (2009). ACCORDING TO THE OBAMA ADMINISTRATION, 4.5 MILLION FAMILIES RECEIVED A TAX REFUND FROM THE AOTC IN 2009, FOR WHICH THEY WOULD NOT HAVE BEEN ELIGIBLE IN 2008.

<sup>8</sup> U.S. TREASURY DEPARTMENT (2010).

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<sup>3</sup> HASKINS (2008).

<sup>4</sup> FOR MORE INFORMATION ON THIS RESEARCH, SEE SHERRADEN (2009), ZHAN AND SHERRADEN (2009), ZHAN AND SHERRADEN (2010), AND ELLIOT AND BEVERLY (2010) OR VISIT [HTTP://COLLEGESAVINGSINITIATIVE.ORG](http://collegesavingsinitiative.org)

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would be invested in principal protected options – currently offered by virtually all 529 plans – while students and families would have a range of investment options from which to choose for their own contributions to the plans. This would allow balances to build up over time, potentially impacting student aspirations at a much earlier age.

Providing tax credits in advance is not without precedent. Currently, families can advance the Earned Income Tax Credit (EITC), and credits can even be routed through an institution such as an employer. In addition, a new Health Care Tax Credit (HCTC) allows LMI families to purchase medical insurance via newly-created insurance exchanges based on tax returns from two years prior to when coverage begins, and the government will submit the credit directly to an insurance company. In the case of advancing the AOTC, the institution would be the financial institution (or program manager) managing the 529 plan, and the structure already exists for delivering funds from 529 plans directly to higher education institutions. While take-up rate and administrative issues have been problematic for the Advanced EITC, an Advanced AOTC would be far simpler to deliver as a single deposit into an existing 529 plan (rather than a weekly payout like the Advanced EITC).

Moreover, funds from 529 college savings plans can only be used for qualified higher education expenses without incurring a tax penalty, and contributions can come from multiple sources. In addition, several states have matching programs – with varying criteria – for LMI contributors to 529s in their states. This provides a universal platform for depositing federal money into 529s, and has the added benefit of preventing families from claiming the AOTC and using it for purposes other than postsecondary education. Additional safeguards and penalties could be created to prevent unqualified withdrawals using monies from the tax credits, and ostensibly the AOTC would be eligible to be claimed for up to four years, which is the case under current law.

Monies contributed via tax credits would be separated in “shadow” accounts, under the same statement, from monies contributed directly by the individual or non-government source (such as relatives, friends, and scholarships). Thus, if the student does not attend college within fifteen years of first claiming the credit, any government monies accumulated from the tax credit would then be required to be paid back to the IRS. Interest accrued could also be required to be returned, based on a calculation involving the Consumer Price Index and the years the credit was claimed.<sup>9</sup> Individuals would still keep the remaining balances in their plan from their own contributions, and could continue to contribute and rollover to another beneficiary for higher education expenses.

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Allowing families the option of claiming the AOTC (or a portion thereof) and depositing the credit into a 529 college savings plan when the child enters 8th grade would remedy issues of timing and access, while potentially impacting student aspirations at an earlier age.

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By not extending the maximum credit from \$2,500 – as well as keeping the four-year limit on claiming the AOTC in place and using an existing savings plan structure in 529s – such a program could be largely cost-effective, and could potentially be revenue-neutral if partial refundability of the

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<sup>9</sup> A TRADITIONAL 8<sup>TH</sup> GRADER WHOSE PARENTS CLAIMED THE CREDIT AT AGE 13 WOULD BE ELIGIBLE TO USE THE MONIES ACCUMULATED FROM THE AOTC UNTIL AGE 28, WHICH IS THE AVERAGE AGE OF COMMUNITY COLLEGE STUDENTS IN THE UNITED STATES (FOR MORE, SEE THE AMERICAN ASSOCIATION OF COMMUNITY COLLEGES’ 2010 FACT SHEET. AVAILABLE AT: [HTTP://WWW.AACC.NCHE.EDU/ABOUTCC/DOCUMENTS/FACTSHEET2010.PDF](http://www.aacc.nche.edu/aboutcc/documents/factsheet2010.pdf)).

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credits were maintained. Seeding accounts with tax credits, thus, provides families with an opportunity to make early financial preparation for higher education, increase balances over time, and leverage existing savings structures to make college more accessible and affordable, with a relatively small cost to taxpayers.

### *Challenges*

Currently, tax filers can make deposits into existing 529 accounts that have routing numbers, but those who have not opened a 529 before filing their taxes cannot do so. Allowing these taxpayers to open a 529 at tax time, directly on their federal income tax forms, would be essential to delivering early, targeted tax credits. However, there is precedent for opening accounts and investing in financial products at tax time. As of 2010, after five years of piloting in several major American cities, Americans are now able to purchase U.S. Savings Bonds directly on their federal income tax forms, and the Treasury Department is exploring how other accounts might be opened at tax time. Several federal legislative proposals would also authorize the opening of various types of accounts at tax time.<sup>10</sup>

To ensure the safety of the monies in each account, the Treasury Department may be required to both mandate principal-protected options to those states that do not currently offer them, as well as provide guidance for default investment options for individuals to deposit the tax credit into a college savings plan.

Finally, while each state offers a unique 529 plan, individuals are currently permitted to participate in any state's plan regardless of residency – though benefits vary

among plans. Whether or not an individual's credit should automatically be deposited into his or her own state plan merits further examination.

## **Reforming the Saver's Credit to Reach LMI Families and Include College Savings**

The Saver's Credit is a federal tax credit enacted in 2001 to encourage low- and moderate-income workers to save for their retirement. It currently provides a match of between 10 and 50 percent for contributions of up to \$2,000 annually to qualified retirement accounts such as 401(k)s and Individual Retirement Accounts (IRAs). The Saver's Credit is one of the few federal tax incentives targeted to help low- and moderate-income families save, and it helps them accumulate larger balances than would be possible otherwise, but only 6 million out of an eligible 50 million families claimed the credit in 2008.<sup>11</sup> This is due to several inherent flaws in the current structure of the credit.

First, the credit is not refundable, so many LMI families with no tax liability are ineligible. In addition, the match rate is overly complex and varies by income, so many families have a watered-down incentive to save. Additionally, families must already be enrolled in a retirement account prior to claiming the credit. Finally, only savings in qualified retirement accounts are eligible for the credit, which precludes families from receiving the same tax benefit to combat the rising cost of college.

The Obama Administration has proposed refundability of the credit, as well as modification of the match rate to 50 percent (up to \$500) on qualified savings per individual.<sup>12</sup>

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<sup>11</sup> TAX FILING STATISTICS RETRIEVED FROM IRS.GOV (2010). "INDIVIDUAL INCOME TAX RETURNS: SELECTED INCOME AND TAX ITEMS. 2008.):

[HTTP://WWW.IRS.GOV/TAXSTATS/INDTAXSTATS/](http://www.irs.gov/taxstats/indtaxstats/)

<sup>12</sup> THIS WOULD ALSO BE ACCOMPLISHED BY THE SAVINGS FOR AMERICAN FAMILIES' FUTURE ACT (HR 1961 AND S. 3090). HR1961 WOULD ALSO RAISE INCOME ELIGIBILITY TO REACH FURTHER INTO THE MIDDLE CLASS, AT \$65,000 (UP FROM \$55,000), AND WOULD AUTOMATICALLY DEPOSIT MATCHING FUNDS INTO PERSONAL RETIREMENT ACCOUNTS BY USING IRS FORM 8888.

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<sup>10</sup> THE SAVER'S BONUS ACT AND ANOTHER POLICY PROPOSAL CALLED THE SAVINGS AND FINANCIAL ELECTRONIC TRANSACTION (SAFE-T) ACCOUNT WOULD ALLOW TAX FILERS TO OPEN ACCOUNTS DIRECTLY ON THE FEDERAL TAX FORM. FOR MORE INFORMATION ON THE SAVER'S BONUS, SEE NEWVILLE (2009), AND FOR MORE ON THE SAFE-T ACCOUNT, SEE [HTTP://ASSETS.NEWAMERICA.NET/SAVINGS\\_AND\\_FINANCIAL\\_ELECTRONIC\\_TRANSACTION\\_ACCOUNTS\\_SAFE\\_T\\_ACCOUNTS](http://assets.newamerica.net/savings_and_financial_electronic_transaction_accounts_safe_t_accounts)

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The Obama Administration has also proposed that the credit become refundable and be modified such that the match rate would be 50 percent (up to \$500) on qualified savings per individual per year. The Administration's proposal would not make college savings accounts eligible for the credit, though there have been legislative proposals to do so.<sup>13</sup> Enacting both proposals would provide a unique incentive for LMI families to save for a child's college education, and unlike the American Opportunity Tax Credit, the Saver's Credit can be claimed in any tax year, allowing families to build wealth over a number of years.

The proposal would not make 529s eligible for the credit, but this would be accomplished by a bill currently in Congress, H.R. 1351. Enacting both proposals would give low- and moderate-income families across the country a strong incentive to save for their children's college education and a means of amassing sizable balances over time. Currently, families can split federal tax refunds via IRS form 8888, a portion of which can be deposited into a qualified retirement account. As it stands, tax filers can make deposits into existing 529 accounts that have routing numbers, but those who have not opened a 529 before filing their taxes cannot. Therefore, as in the Advanced AOTC recommendation, all 529 plans would be required to have a routing number, or families could be allowed to enroll in college savings plans on the federal tax form.<sup>14</sup>

## Financial Aid, Savings, and Impact

The past two decades have seen tuition inflation far outpace growth in family income. Simultaneously, college attendance rates have increased while college completion rates have remained sluggish. Meanwhile, financial aid to LMI students has stagnated: In 1987-88, the maximum Federal Pell Grant covered 50% of public higher education costs. In 2010, it covers only 34%.<sup>15</sup> In 2008, 86.9% of Pell

Grant recipients graduated with student loan debt compared to 50.2% of non-Pell Grant recipients, with Pell recipients accumulating on average \$3,500 more in debt than non-Pell recipients.<sup>16</sup>

Simultaneously, the Obama Administration proposed \$549.1 billion for FY2011 in tax incentives on savings and wealth building, the vast majority of which accrue to middle- and upper-income families, and most of which incentivize saving for retirement and homeownership. 529 plans were created by states and given tax-advantaged status to help families keep up with the rising cost of education, though many LMI families have little or no incentive to save. However, a broad body of research indicates that, when given incentives and well-designed accounts, LMI families can save for a range of life goals, including college.<sup>17</sup>

Enacting the policies listed above will likely require answering questions of design, cost, and interaction with existing policies – particularly financial aid. However, capitalizing college savings accounts with tax credits in an early, targeted, and cost-effective approach could have a broad impact on college aspirations, access, and completion.

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## The College Savings Initiative

The College Savings Initiative was launched in 2009 as a joint venture of the New America Foundation and the Center for Social Development (CSD) at Washington University in St. Louis, supported by the Lumina Foundation for Education and the Bill & Melinda Gates Foundation. For more information about the College Savings Initiative please visit:

[www.collegesavingsinitiative.org](http://www.collegesavingsinitiative.org)

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<sup>13</sup> HR 1351: THE SAVINGS ENHANCEMENT FOR EDUCATION IN COLLEGE ACT. 110TH CONGRESS.

<sup>14</sup> NEWVILLE (2009).

<sup>15</sup> COLLEGE BOARD (2010)

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<sup>16</sup> KANTROWITZ (2009).

<sup>17</sup> SHERRADEN (2009).

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