

Federal Tax Provisions Affecting Colleges and Universities

Through teaching, research and innovation, and public service, America's colleges and universities make critical contributions to our society. Collegiate experience impacts students – as compared to those without it – in a number of ways: higher lifetime earnings, better health, and greater civic engagement. With good wages and benefits, colleges and universities are often the largest and most stable employer in their communities. Traditional nonprofit public and private colleges and universities have historically been granted tax-exempt status, which permits them to use more resources to fund academic research, student financial aid, and community programs to achieve their core missions of teaching, research, and public extension. The Federal Tax Code impacts colleges and universities' missions through provisions affecting: aid to students, incentives for charitable giving, tax-exempt financing, unrelated business income, and the R&D tax credit.

The following are key provisions of the Tax Code affecting colleges and universities:

- **American Opportunity Tax Credit (AOTC)** – *expires on December 31, 2017.*
- **Lifetime Learning Credit**
- **Tuition Deduction** – *expired on December 31, 2013.*
- **Section 127 Employer-provided Educational Assistance**
- **Section 117 Qualified Scholarships**
- **Student Loan Interest Deduction (SLID)**
- **Coverdell Education Savings Accounts**
- **Section 529 Education Savings Plans**
- **Federal Loan Forgiveness Programs**
- **Charitable Income Tax Deduction**
- **IRA Charitable Rollover** – *expired on December 31, 2013.*
- **Tax-exempt Bonds**
- **Build America Bonds** – *expired on December 31, 2010.*
- **R&D Tax Credit** – *expired on December 31, 2013.*
- **Unrelated Business Income Tax (UBIT)**

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Aid to Students

The tax provisions described below were enacted to help make college more affordable. Federal tax credits for higher education expenses encourage greater access to and participation in higher education.

- **American Opportunity Tax Credit (AOTC)** – expires on December 31, 2017. The AOTC is a partially refundable tax credit, up to \$2,500, that may be claimed for qualified tuition, fees, and required course materials expenses of each student in a taxpayer's family. To use the credit, a student must be enrolled: at least half-time, during the first four years of postsecondary education; and in a program leading to a degree, certificate, or other recognized credential. The AOTC is subject to an income phase-out beginning at \$80,000 for an individual (\$160,000 for joint filers) and ending for income above \$90,000 (\$180,000 for joint filers). The AOTC is 40% refundable. Without extension, AOTC reverts back to the Hope Scholarship tax credit benefit of \$1,800 with narrower eligible education expenses and shorter period of eligible use, lower income thresholds, and no refundability.
- **Lifetime Learning Credit** – The credit is a non-refundable tax credit of up to \$2,000 for qualified education expenses paid for all eligible students in a family. There is no limit on the number of years that the credit may be claimed for each student. In contrast to the AOTC, eligible expenses are limited to tuition and fees paid for the student. The credit can be claimed for a student enrolled in an undergraduate or graduate degree program or any course of instruction at an eligible school to acquire or improve the student's job skills. The credit is subject to income limits of \$60,000 for single filers (\$120,000 for joint filers).
- **Tuition Deduction** – expired on December 31, 2013. The above-the-line deduction for qualified tuition and related expenses allows students or parents to deduct up to \$4,000 in eligible higher education expenses from their taxable income. Eligible expenses are limited to tuition and fees paid for the student. To claim the deduction, a student must be enrolled in one or more courses at the undergraduate or graduate level. The deduction is subject to an income phase-out beginning at \$65,000 for an individual (\$130,000 for joint filers) and ending for income above \$80,000 (\$160,000 for joint filers).
- **Section 127 Employer-provided Educational Assistance** – Under Section 127, an employee may receive up to \$5,250 in tax-free educational assistance per year from an employer for undergraduate or graduate-level courses. Tax-free educational assistance benefits include payments for tuition, fees and similar expenses, books, supplies, and equipment. The payments do not have to be for work-related courses. Section 127 was permanently extended by the American Taxpayer Relief Tax Act of 2012.

- **Section 117 Qualified Scholarships** – Section 117 excludes scholarship, fellowship, and grant funds (including Pell Grants) from taxation for a student at a college or university who uses the funds for the payment of tuition and fees, books, supplies, and equipment. Funds used for living expenses, such as room and board, are not excludable from income and are therefore subject to taxation. Section 117 also allows employees of certain educational institutions, including nonprofit colleges and universities, to exclude from taxable income qualified undergraduate tuition reductions they, or their dependents, receive from their employer. Neither the institution as an employer or the employee pays federal income tax on the amount paid by the institution for tuition expenses.
- **Student Loan Interest Deduction (SLID)** – SLID is a tax deduction that permits taxpayers to deduct up to \$2,500 in federal student loan interest payments each year. To qualify, a loan must have been taken out solely to pay for qualified education expenses, such as tuition and fees, room and board, and books. SLID is taken as an adjustment to income and therefore can be claimed even if a taxpayer does not itemize deductions. SLID is phased out ratably for taxpayers with AGI between \$60,000-\$75,000 (\$125,000-\$155,000 for joint filers). Certain elements of SLID were permanently extended by the American Taxpayer Relief Tax Act of 2012.
- **Coverdell Education Savings Accounts** – Under Section 530, individuals can contribute up to \$2,000 annually tax-free to pay for qualified education expenses of a designated beneficiary. Individuals remain eligible to contribute with income up to \$110,000 (\$220,000 for joint filing). Qualified education expenses are broadly defined to include tuition, fees, course materials, and room and board. Without extension, maximum contribution returns to pre-2001 level of \$500 per year. Certain elements of Coverdell Education Savings accounts were permanently extended by the American Taxpayer Relief Tax Act of 2012.
- **Section 529 Education Savings Plans** – Under Section 529, states are authorized to sponsor “Qualified Tuition Programs” that are tax-advantaged savings vehicles for qualified post-secondary education expenses, such as tuition, fees, books, required supplies, equipment and room and board. There are two types of 529 Plans: savings plans, which allow families to save for expenses, and pre-paid tuition programs, which generally allow families to make advance tuition payments to cover future attendance at a designated in-state public college or university system. Any U.S. resident or citizen, regardless of income, can open an account. Investments grow on a tax-deferred basis; earnings are free of federal income tax and redemptions are also exempt from federal income tax if used to pay for qualified education expenses.
- **Federal Loan Forgiveness Programs** – The federal government offers four major federal student loan forgiveness programs. Under the terms of two of them – the Public Service Loan Forgiveness (PSLF) and the Teacher Loan Forgiveness Program (TEACH) – the amount of the loan forgiven is not subject to federal income tax. This is not the case for the other two programs – Income Based Repayment (IBR) and Income Contingent Repayment (ICR). Rather, a borrower who receives loan forgiveness is subject to income tax on the amount of the loan forgiven.

Incentives for Charitable Giving

- **Charitable Income Tax Deduction** – Tax law permits taxpayers to partially deduct gifts made to charities organized under Tax Code Section 501(c)(3). While donors make charitable gifts for many reasons, it is well established that the charitable tax deduction is an effective incentive that helps generate and sustain donations. Charitable deductions are generally limited to no more than 50% of a taxpayer's AGI. In this challenging economic climate, charitable gifts are an increasingly critical source of support for colleges and universities. In 2010, higher education institutions received \$28 billion in charitable gifts to support their missions of teaching, research, and public service. Some gifts are used to fund current operations; however, many gifts are given specifically to an institution's endowment so that they will support specific purposes or activities – such as student scholarships or medical research – for many years to come.

- **IRA Charitable Rollover** – *expires on December 31, 2013*. The IRA Charitable Rollover tax incentive allows individuals age 70½ and older to donate up to \$100,000 from their Individual Retirement Accounts (IRAs) and Roth IRAs to public charities, including colleges and universities, without having to count the distributions as taxable income. The IRA Charitable Rollover is an important recent addition to the federal income tax code that further incentivizes charitable giving. It is particularly beneficial to so-called “non-itemizers” – individuals who do not itemize tax deductions. The IRA Charitable Rollover was last extended by the American Taxpayer Relief Tax Act of 2012.

Tax-advantaged Financing

- **Tax-exempt Bonds** – Under Tax Code Section 103(a) the interest earned on tax-exempt bonds issued by state and local governments is excludable from gross income for purposes of federal income taxes. Investors are generally willing to receive a lower rate of return on their investments than they might otherwise accept on taxable investments. Thus, the tax exempt bonds carry a lower cost of capital to the beneficiary (e.g. a university) of the bond proceeds. States can issue two kinds of tax-exempt bonds: 1) *governmental bonds* – the proceeds are used to finance governmental functions (e.g. build public schools or roads) or the proceeds are repaid with governmental funds; and 2) *private activity bonds* – the state or local government serves as the conduit for obtaining and providing the tax-exempt bond financing to certain nongovernmental entities, including private colleges and universities.
- **Build America Bonds** – *expired on December 31, 2010*. Build America Bonds were taxable governmental bonds, the interest on which was subsidized by the Federal government by means of a 35% tax credit to the holder or, in the case of certain qualified bonds (for capital expenditures), by a direct payment to the issuer.

Research and Development Tax Credit

- **R&D Tax Credit** – *expired on December 31, 2013*. The R&D tax credit is a business tax credit for qualified research expenses that can be deducted from overall corporate income taxes. Current law allows companies to claim the credit for R&D activities conducted at universities or other qualifying organizations, including research consortiums which may include universities. Universities benefit indirectly from the R&D tax credit. The tax credit encourages industry to take on new R&D challenges that are important to industry but also well-suited to academic research. When companies contract with universities to conduct R&D, faculty and students benefit from receiving complex academic and practical research problems and the financial support to study them. The R&D tax credit, in turn, promotes greater collaboration between industry and universities, including employment opportunities for students and graduates. The R&D tax credit also fosters start-up companies, many of which grow out of new technologies developed at universities. The R&D Tax Credit was last extended by the American Taxpayer Relief Tax Act of 2012.

Unrelated Business Income Tax (UBIT)

- **UBIT** – Although colleges and universities are tax-exempt entities, they are subject to tax on any unrelated business income they may generate. Recurring UBIT issues for higher education institutions include: 1) determining whether a particular activity is educational in nature, and therefore, qualifies for tax-exempt treatment; and 2) determining whether a non-educational activity is exempt from UBIT because income from the activity fits within a statutory exemption. An example of a university income-generating activity that is subject to UBIT is income from sales of non-educational materials such as CDs, DVDs, and other gift items by a campus bookstore.