Legislative Fiscal Bureau
One East Main, Suite 301 • Madison, WI 53703 • (608) 266-3847 • Fax: (608) 267-6873

June 8, 2007 | Joint Committee on Finance | Paper #316

Increase Deduction for College Tuition (General Fund Taxes -- Individual and Corporate Income Taxes)

Bill Agency

[LFB 2007-09 Budget Summary: Page 152, #2]

CURRENT LAW

Current law provides an individual income tax deduction for tuition expenses paid on behalf of a taxpayer or the taxpayer's dependent. Eligible expenses include tuition paid to any university, college, technical college, or a school approved by the Educational Approval Board that is located in Wisconsin. The deduction also applies to tuition expenses for a public vocational school or public institution of higher education in Minnesota under the Minnesota-Wisconsin tuition reciprocity agreement.

Currently, the maximum deduction that may be claimed per eligible student is equal to twice the average amount charged by the Board of Regents of the University of Wisconsin System at four-year institutions for resident undergraduate academic fees for the most recent fall semester. The maximum deduction was $4,536 for 2006, and, under current law, is $4,844 for 2007. For non- and part-year residents, the tuition deduction must be pro-rated based on the share of a taxpayer's total income that is taxable to Wisconsin, and may not exceed a taxpayer's total income taxable by the state. The maximum deduction is phased out in specified ranges of federal AGI that vary with filing status. The phase-out ranges are as follows: (a) $50,000 to $60,000 for single and head-of-household tax filers; (b) $80,000 to $100,000 for married couples filing joint returns; and (c) $40,000 to $50,000 for married couples filing separate returns.

In addition to the deduction for tuition expenses, current federal and state laws also provide certain tax advantages for Section 529 college savings plans [the term "Section 529" refers to the section of the Internal Revenue Code (IRC) authorizing such plans.] For state tax purposes, donors to Wisconsin Section 529 plans may deduct up to $3,000 in contributions to an account if the beneficiary is the purchaser, the purchaser's spouse, or the purchaser's dependent child or if the contribution is made by a beneficiary's grandparent, great-grandparent, aunt, or uncle. In addition, earnings and qualified distributions from Section 529 accounts are exempt from taxation under both federal and state tax laws.

Finally, other federal and state income tax provisions provide for favorable treatment of expenses related to higher education. These provisions, are described in the Appendix to this paper.

GOVERNOR

Increase the maximum college tuition deduction to $6,000 per eligible student per year, effective with taxable years beginning after December 31, 2006, and specify that the deduction would apply with respect to mandatory student fees as well as tuition expenses.

In addition, clarify that a tuition deduction may not be claimed if the source of the payment is an amount withdrawn from a Wisconsin Section 529 account and if the owner of the account has claimed a deduction that relates to the amount paid for tuition expenses and fees.

The administration has estimated that the proposal would reduce state income tax revenues by $2.4 million in 2007-08 and by $1.6 million in 2008-09.

DISCUSSION POINTS

1. As noted, the maximum tuition deduction under current law is based on average amounts charged by the Board of Regents of the University of Wisconsin System (UW System) at four-year institutions for resident undergraduate academic fees for the most recent fall semester. As a result, as long as tuition at such institutions continues to increase on an annual basis, the current law maximum deduction will also increase annually. Prior to tax year 2005, the maximum deduction was limited to $3,000 per year. The annual increases based on average tuition at the UW System were enacted under 2005 Act 25.

2. Under current law, the maximum tuition deduction for tax year 2007 is $4,844 per eligible student. DOR has estimated the maximum deduction for tax year 2008 at $5,200 per eligible student. Under the proposal, the maximum tuition deduction would be set at $6,000 per year, starting in tax year 2007. Compared to current law, the proposal would increase the maximum deduction by $1,156 per eligible student for tax year 2007 and would be estimated to increase the maximum deduction by $800 per eligible student for tax year 2008.

3. Under the bill, the tuition deduction would also be modified to apply to both tuition and mandatory student fees. While the provisions would not define "mandatory student fees," the administration has indicated that the term is intended to include fees charged to all students in

addition to tuition, fees for materials and other fees that must be paid to participate in certain classes, and any other instructional fees.

4. The UW System campus charges a segregated fee to all students in addition to tuition. This fee varies by campus, but is the same for all students regardless of residency status. In 2006-07, these segregated fees range from $585 to $1,148 at the four-year campuses and from $209 to $337 at the two-year UW Colleges campuses. The average segregated fee, weighted by campus population, is about $700.

5. In addition, students enrolled in certain programs, such as pharmacy at UW-Madison and the College of Nursing at UW-Milwaukee, are charged more than other students. However, the UW System treats these additional charges as additional tuition (termed academic student fees in the statutes), not as fees. Therefore, such additional charges are already eligible for the tuition deduction under current law.

6. At the Wisconsin Technical College System, based on the latest available data, fees for materials and other fees and charges average approximately $440 per full-time student annually.

7. Based on the average fees described above, it appears that the proposed $6,000 maximum deduction amount would be sufficient to cover the sum of the average tuition amounts and average fees described above at least through tax year 2008.

8. The administration has estimated that the proposal would reduce state income tax revenues by $2.4 million in 2007-08 and by $1.6 million in 2008-09. The higher estimated cost of the proposal in the first year reflects the greater difference between the current law maximum deduction and the proposed $6,000 maximum deduction in that year ($1,156, compared to an estimated $300 in the second year). The estimates appear to be reasonable.

9. The current law maximum tuition deduction for tax year 2007 increased by 6.8% over the maximum deduction for tax year 2006. The estimated maximum deduction under current law for 2008 represents 7.3% growth over 2007. If this rate of annual increase were to continue, the maximum deduction under current law would be expected to exceed the maximum deduction under the proposal starting with tax year 2011. Therefore, while the proposal is expected to result in a higher maximum deduction for tax years 2007 through 2010, it appears that the proposed maximum would be lower than the current law maximum in subsequent years. In addition, under the Governor's proposal, as tuition increased, the amount of the deduction that would be available to use with respect to mandatory student fees would decrease. Because there would be no mechanism to automatically increase the maximum deduction over time, the proposal would eventually result in a lower maximum deduction than the deduction available under current law.

10. Another option would be to modify the proposal to also provide for annual increases in the maximum deduction, similar to the increases provided under current law. As noted, it appears that the proposed maximum deduction of $6,000 would be sufficient to cover both average tuition and average fees through tax year 2008. Therefore, one possibility would be to provide for annual

increases in the maximum deduction starting with the deduction for tax year 2009. For example, the maximum deduction could still be increased annually by means of a reference to twice the average amount charged by the Board of Regents of the University of Wisconsin System at four-year institutions for resident undergraduate academic fees for the most recent fall semester. However, rather than setting the maximum equal to the average tuition figure, which would not take student fees into account, the maximum tuition deduction could be increased by the percentage increase in the average tuition amount over the amount for the prior year. Under this approach, the amount of the deduction available to cover student fees would increase annually at the same rate as the increase in average tuition. Compared to the bill, there would be no fiscal effect of such a modification in the 2007-09 biennium. However, for subsequent years, compared to current law, it is anticipated that providing for annual increases in the maximum tuition deduction would reduce individual income tax revenues by $1.6 million (in 2008-09 dollars) per year.

11. As noted, the bill would also clarify that a tuition deduction may not be claimed if the source of the payment is an amount withdrawn from a Wisconsin Section 529 account and if the owner of the account has claimed a deduction that relates to the amount paid for tuition expenses and fees. Currently, no amount may be claimed as a deduction for tuition expenses if the source of the payment is an amount withdrawn from a Wisconsin Section 529 account if the <u>claimant</u> has already claimed a deduction that relates to the amount paid for tuition expenses. The bill would modify this provision to disallow the deduction if the source of the payment is an amount withdrawn from a Wisconsin Section 529 account and if the <u>owner of the account</u> (rather than the <u>claimant</u>) has claimed a deduction that relates to the amount paid for tuition expenses and fees. The proposed change from "claimant" to "owner of the account" is intended to prevent a situation in which a double deduction could be claimed for amounts contributed to a Wisconsin Section 529 account and subsequently used to pay tuition. Under current law, the owner of a Wisconsin Section 529 account could make a tax-free contribution to the account on behalf of a beneficiary, and the beneficiary, acting as the claimant for purposes of the tuition deduction, could claim a second tax deduction on the same amount when using a distribution from the account to pay for tuition. Under the proposed modification, such a beneficiary would not be able to claim a tuition deduction on such an amount.

12. It should be noted that an increase in the tuition deduction would provide a tax benefit to certain taxpayers, but other individuals and families with tuition expenses would not receive a benefit. For example, lower-income families and individuals that do not currently have a tax liability would not receive a benefit. To illustrate, a self supporting student with annual income below the sum of the personal exemption amount ($700) and the income threshold for receiving the maximum sliding scale standard deduction ($11,700) would not owe any income taxes under current law and would, therefore, not receive a benefit from the proposal. Others without a benefit would include those with federal AGI exceeding the maximum income levels for the phase-out of the deduction ($60,000 for single individuals and heads-of-households, $100,000 for married taxpayers filing joint returns, and $50,000 for married individuals filing separate returns). Such taxpayers would be ineligible for the deduction both under current law and under the proposal.

13. However, while lower-income families and independent students might not benefit

from the tuition deduction, such taxpayers could benefit from state and federally funded need-based grant programs. The number of eligible students and the average amount of each award are determined by formula using nationally approved needs methodology, which is based on factors including total family income. In the 2005-07 biennium, $91.3 million was provided for need-based assistance through the Higher Educational Aids Board (HEAB). The Governor has proposed an increase of $21.5 million in available funding for such assistance in the 2007-09 biennium.

ALTERNATIVES TO BILL

1. Approve the Governor's proposal.

ALT 1	Change to Bill Revenue	Change to Base Revenue
GPR	$0	- $4,000,000

2. Approve the Governor's proposal with a modification to provide for annual increases in the maximum tuition amount, starting with the amount for tax year 2009, based on the percentage increase in twice the average amount charged by the Board of Regents of the University of Wisconsin System at four-year institutions for resident undergraduate academic fees for the most recent fall semester over the prior fall semester. Under this alternative, there would be no change to the estimated fiscal effects included in the bill. For 2009-10 and thereafter, it is estimated that this alternative would reduce individual income tax revenues by an additional $1.6 million annually.

ALT 2	Change to Bill Revenue	Change to Base Revenue
GPR	$0	- $4,000,000

3. Delete provision.

ALT 3	Change to Bill Revenue	Change to Base Revenue
GPR	$4,000,000	$0

Prepared by: Faith Russell

APPENDIX

Federal and State Income Tax Provisions Related to Higher Education Expenses

Coverdell Education Savings Accounts. Married taxpayers filing joint tax returns and individual filers (including the beneficiary) may contribute up to $2,000 per designated beneficiary per year to a Coverdell Education Savings Account (CESA, formerly called an Education IRA). There are no relationship requirements between the contributor and the beneficiary. While contributions are not deductible from income, interest earnings are tax exempt and withdrawals are excluded from the beneficiary's income if used for eligible education expenses. Under coordination rules with other tax deductions and credits for education, qualified expenses for purposes of a CESA are reduced to reflect other education tax benefits taken.

The ability of an individual to make a contribution to a CESA is gradually phased out for contributors with taxable income between $95,000 and $110,000 (between $190,000 and $220,000 for joint filers). Starting with tax year 2002, funds from a CESA may be used to pay for qualified elementary and secondary education expenses in addition to qualified higher education expenses.

Education Savings Bonds. Federal law excludes from income interest from qualified U.S. savings bonds that are cashed in and used to pay for qualified higher education expenses. The exclusion is phased out at higher income levels. Under state law, all interest from U.S. savings bonds is exempt, regardless of whether or not the interest is used to pay for qualified educational expenses.

Employer Payment of Educational Expenses. Payments of up to $5,250 received by an employee for tuition, fees, and supplies may be excluded from income for both federal and state income tax purposes.

Higher Education Tax Deduction (Federal). Federal law provides a deduction for up to $4,000 of qualified higher education expenses. The maximum deduction is phased out for federal adjusted gross income between $65,000 and $80,000 ($130,000 to $160,000 for married couples filing joint returns). The federal deduction first applied for tax year 2002, when the maximum deduction was $3,000. The deduction was increased to $4,000 starting in 2004, and is set to expire at the end of tax year 2007. The state does not conform to this federal provision, as the state provides its own tuition deduction.

Hope Credit. Hope credits are available to individuals who pay qualified tuition and related expenses of higher education for either themselves or a dependent. Degree-seeking students who are enrolled at least half-time and are in one of the first two years of college are eligible for a tax credit of up to 100% of the first $1,000 and 50% of the second $1,000 in tuition expenses. Eligible expenses include tuition and required fees less any grants, scholarships or other tax-free financial assistance. For tax year 2006, the credit is gradually phased out for taxpayers with taxable incomes between $45,000 and $55,000 for single filers and between $90,000 and $110,000 for joint filers. The maximum credit amounts and income limits are indexed for inflation.

IRA Withdrawals for Education Expenses. Early withdrawals (before age 59½) from a traditional IRA are not subject to the 10% federal tax penalty (or a state penalty, which is typically 33% of the federal penalty) provided that distributions are used for postsecondary education expenses of the taxpayer, spouse, child, or grandchild.

Lifetime Learning Credit. Tax filers may claim a lifetime learning tax credit if they pay qualified tuition and related expenses of higher education for an eligible student, either themselves, a spouse, or a dependent, who is claimed as an exemption. Students beyond the first two years of college or those enrolled less than half-time are eligible for a 20% tax credit on the first $10,000 in expenses. Eligible expenses include tuition and required fees less any grants, scholarships, or other tax-free financial assistance. In 2006, the credit was phased out for taxpayers with taxable incomes between $45,000 and $55,000 for single filers, and between $90,000 and $110,000 for joint filers.

Federal law does not allow a double benefit with respect to the tax treatment of higher education expenses. For example, neither the Hope nor the lifetime learning credits may be claimed for higher education tuition expenses that were deducted from federal income. Similarly, a Hope credit and a lifetime learning credit may not be based on the same qualified education expenses. However, a state resident may deduct qualified tuition expenses for state tax purposes even if such expenses have been included in the calculation of the federal Hope or lifetime learning credits.

Student Loan Interest Deduction. For federal and state income tax purposes, an individual may deduct up to $2,500 of interest paid on student loans for qualified higher education expenses. The deduction is phased out for single filers with modified federal AGI (prior to taking the student loan interest deduction) between $50,000 and $65,000 and for joint filers with income between $100,000 and $130,000.