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# The Federal Tax System and Treatment of Scholarships for Graduate Students: Should Scholarships Be Taxed?

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# THE FEDERAL TAX SYSTEM AND TREATMENT OF SCHOLARSHIPS FOR GRADUATE STUDENTS: SHOULD SCHOLARSHIPS BE TAXED?

## I. INTRODUCTION

This Note addresses the tax disadvantage that non-scholarship graduate school students[1] face when compared with graduate students that receive scholarships.[2] The disadvantage is present whether the students are enrolled in school or have already graduated. While in school, students paying tuition out of their own pockets pay with money that has already been subjected to federal and state income taxes. Students who use scholarship funds to pay tuition are not taxed on the scholarship income at all.[3] Therefore, non-scholarship students pay disproportionately more taxes when it comes to their education, an economic disadvantage that becomes more obvious after graduation. Because of the high cost of tuition at graduate schools, students most likely have to take out at least a partial loan to finance their degree.[4] Once graduated, these students repay the loans with income that has been taxed. However, students with full scholarships do not have to use their after-tax dollars to repay any educational loans. Furthermore, students who received a partial scholarship are repaying a smaller amount of loan money, and consequently

1. Graduate school is defined as "a school in a university offering study leading to degrees beyond the bachelor's degree." WordNet (1997), *at* http://cogsci.princeton.edu/cgi-bin/webwn 2.0?stage=1&word=graduate+school (last visited Apr. 13, 2004). In this Note, graduate school will refer to those schools that grant masters, doctorate, law, medical, and other professional degrees.

2. A scholarship is any cash amount paid to or for the benefit of an individual to aid in the pursuit of study. Treas. Reg. § 1.117-6(c)(3) (2003). A scholarship may also be recognized in the form of a tuition reduction and need not specifically be designated as a scholarship. *Id.* However, amounts given by friends, relatives, or other individuals motivated by philanthropic contributions do not qualify as a scholarship. *Id.*

3. Scholarships are not included in a taxpayer's gross income for the year. I.R.C. § 117(a) (2003). Items not included in gross income are not taxable. *Id.* § 63(a).

4. One of the primary ways graduate students finance their education is by taking out student loans. J. Timothy Phillips & Timothy G. Hatfield, *Uncle Sam Gets the Goldmine—Students Get the Shaft: Federal Tax Treatment of Student Loan Indebtedness*, 15 SETON HALL LEGIS. J. 249, 251 (1991). Sixty percent of all graduate students and eighty-two percent of full-time graduate students received some type of financial aid for the 1999-2000 school year. Susan P. Choy & Sonya Geis, *Student Financing of Graduate and First-Professional Education: 1999-2000*, *at* http://nces.ed.gov/pubs2003/quarterly/fall/4_3.asp (last visited Apr. 13, 2004).

pay fewer taxes on their education than those students with no scholarship at all. Regardless of whether non-scholarship students paid tuition out of pocket or with loans, they use after-tax dollars to finance their education. Therefore, scholarship students pay significantly less for their education in both tuition and taxes.

One of the goals of the tax system is to spread the burden equally and fairly.[5] However, the tax burden is unequally distributed for students in graduate school. Students without scholarships currently shoulder more of the burden and, because of this inequality, face economic and tax disadvantages. To alleviate this problem, scholarships awarded to graduate students should be taxed as income.

Part II of this Note will discuss the historical background of sections 117 and 127 of the Internal Revenue Code. Section 117 provides that all scholarships are to be tax-free[6] and section 127 provides guidance for employer educational assistance programs.[7] This part also will show a differentiation between undergraduate and graduate students and argue that scholarships should be treated differently for graduate students. Part III will discuss the current tax breaks available to graduate students and explain why they fail to level the playing field. Part IV will analyze the need for higher education, the cost of education, and why scholarships for graduate students should be taxed to alleviate the current inequalities. Finally, Part V will conclude that scholarships should be taxable as income for graduate students and propose alternative solutions to this problem.

## II. HISTORICAL BACKGROUND

### *A. Historical Background of Section 117*

Prior to 1954, scholarships were not specifically addressed by any section of the Internal Revenue Code, but they were excludible under the general

5. The underlying goal of the tax system is to "raise revenue equitably and efficiently." David M. Schizer, *Frictions as a Constraint on Tax Planning*, 101 COLUM. L. REV. 1312, 1360 (2001). Fairness is also another goal of tax law. Jacqueline T. Albus, Comment, *The Deduction for Interest on Student Loans: Relief is on the Way*, 42 ST. LOUIS U. L.J. 591, 611 (1998). One of Congress's concerns is to ensure that the American taxpayers feel that the tax system is fair and equitable. Issues Presented by Proposals to Modify Tax Treatment of Expatriation, Pub. L. No. 104-7, 109 Stat. 93, 78 (1995). "[O]ur intent is to provide greater equity in the tax system, a goal that will encourage greater confidence in our Government as a whole." General Explanation of the Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085, 1239 (1986). The Court also agrees that the primary goal of the tax system is to collect revenue equitably. Thor Power Tool Co. v. Comm'r, 439 U.S. 522, 542 (1979).

6. I.R.C. § 117(a) (2003).

7. *See generally id.* § 127.

provision exempting gifts.[8] Although there were no specific rules regarding whether a grant towards education constituted a gift, "each grant was subjected to a 'gift vs. compensation' test."[9] Congress enacted section 117 in 1954 to expand the scope of exclusions for scholarships.[10] Further, by providing a bright-line rule, Congress sought to avoid the volume of case-by-case litigation that had resulted under the prior law.[11] "[T]he fundamental goal of federal involvement in higher education has been to encourage and provide access to all individuals regardless of income level."[12] To achieve this goal, Congress exempted scholarships from gross income through section 117.[13]

Section 117(a) currently excludes qualified scholarships[14] received by individuals who are candidates for degrees at qualified educational organizations.[15] To be considered a qualified scholarship, the scholarship funds must be used toward tuition and related expenses.[16] Although the terms of the scholarship are not required to expressly provide for these uses, the terms cannot expressly preclude them either.[17] If any or all of the funds are so precluded, that portion is not considered a qualified scholarship and is subject to taxation.[18]

In 1986, Congress limited the scope of the scholarship exemption by repealing the exemption for teaching, research, and other services required for

8. Richard C.E. Beck, *Loan Repayment Assistance Programs for Public-Interest Lawyers: Why Does Everyone Think They are Taxable?*, 40 N.Y.L. SCH. L. REV. 251, 258 (1996). *See also* Robert W. Lee, *The Taxation of Athletic Scholarships: An Uneasy Tension Between Benevolence and Consistency*, 37 U. FLA. L. REV. 591, 592 (1985).

9. Lee, *supra* note 8, at 592. The value of property acquired by gift is excluded from gross income. I.R.C. § 102(a) (2003). Under this gift versus compensation test, scholarships were often considered gifts and therefore escaped taxation. Lee, *supra* note 8, at 592.

10. Beck, *supra* note 8, at 258.

11. *Id.* at 258-59.

12. Natasha Mulleneaux, *The Failure to Provide Adequate Higher Education Tax Incentives for Lower-Income Individuals*, 14 AKRON TAX J. 27, 27 (1999) (citing *Education and Training Tax Provisions of the Administration's Fiscal Year 1998 Budget Proposal: Hearing Before the House Comm. on Ways and Means*, 105th Cong., (1997) (statement of James B. Appleberry, President, American Association of State Colleges and Universities)).

13. I.R.C. § 117 (2003).

14. "Qualified scholarship" refers to any amount received by an individual as a scholarship or fellowship grant as long as it is used towards qualified tuition and related expenses. *Id.* § 117(b)(1).

15. A "qualified educational organization" is one that "normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on." *Id.* § 170(b)(1)(A)(ii).

16. Qualified tuition and related expenses refers to tuition, fees, books, supplies, and equipment required for the enrollment of a student at an educational organization. *Id.* § 117(b)(2). In order for related expenses to qualify, they must be required of all students in the particular course of instruction. Treas. Reg. § 1.117-6(c)(2)(ii) (2003).

17. Treas. Reg. § 1.117-6(c)(1) (2003).

18. *Id*.

students.[19] If the scholarship or any portion of it represents payment for teaching, research, or other services by the student that are required as a condition for receiving the scholarship, it is also taxable as income.[20] "A requirement that the recipient pursue studies, research, or other activities primarily for the benefit of the grantor is treated as a requirement to perform services."[21] "[A]ny amount of a scholarship . . . that is not excludable under section 117 is includable in the gross income of the recipient for the taxable year in which such amount is received."[22] Therefore, scholarships are taxable to the extent that the student performs a service of value.[23] If only a portion of a scholarship represents payment for services, the grantor must determine that amount by considering factors such as whether he paid students with similar qualifications for similar services, whether he paid for similar services performed by his employees who are not students, or whether educational organizations pay for similar services performed by students or employees.[24] Also, any scholarship given for living expenses is subject to taxation because those expenses are not included in qualified tuition and related expenses.[25]

### *B. Historical Background of Section 127*

The Revenue Act of 1978[26] first established section 127 on a temporary basis.[27] Section 127 was subsequently extended several times by Congress. Prior to 1988, the exclusion provided in section 127 was applicable to graduate-level courses.[28] However, the Technical and Miscellaneous Revenue Act of 1988[29] made the exclusion inapplicable to graduate-level courses.[30] "The exclusion . . . is aimed at increasing the levels of education and training in the workforce."[31] The value of tax savings is greater for taxpayers with higher marginal tax rates because the exclusion is from gross income.[32]

Section 127 treats educational assistance from employers similar to a scholarship. Amounts paid by the employer for educational assistance to an

19. Beck, *supra* note 8, at 260.
20. I.R.C. § 117(c)(1) (2003).
21. Treas. Reg. § 1.117-6(d)(2) (2003).
22. Treas. Reg. § 1.117-6(b)(1) (2003).
23. Beck, *supra* note 8, at 260.
24. Treas. Reg. § 1.117-6(d)(3) (2003).
25. *See supra* note 16 and accompanying text.
26. Pub. L. No. 95-600, 92 Stat. 2763 (1978).
27. Joint Comm. on Taxation, Description and Analysis of Certain Tax Provisions Expiring in 1994 and 1995, JCS-8-95 (May 8, 1995).
28. *Id.*
29. Pub. L. No. 100-647, 102 Stat. 3794 (1988).
30. Joint Comm. on Taxation, Description and Analysis of Certain Tax Provisions Expiring in 1994 and 1995, JCS-8-95 (May 8, 1995).
31. *Id*.
32. *Id.*

employee do not have to be included in the gross income of the employee.[33] However, this assistance exclusion only applies to those working toward undergraduate degrees.[34] "[G]raduate level courses normally taken by an individual pursuing a program leading to a law, business, medical, or other advanced academic or professional degree" are not excludable from gross income.[35] Education involving sports or hobbies, tools or supplies that might be retained by the employee after the course, and meals and lodging are also disqualified under this provision.[36]

One of the key differences between employer assistance under section 127 and excludable scholarships under section 117, in addition to the exclusion of graduate students in section 127, is that according to section 127, only the first $5,250 of assistance by the employer can be excluded from gross income while there is no dollar limit on excludable scholarships under section 117.[37] In order for the employee to utilize this exclusion, a program set up by the employer must furnish the assistance.[38] Additionally, the educational assistance program must be a separate plan of the employer for the exclusive benefit of the employees.[39] The program cannot be discriminatory in favor of highly compensated employees and cannot provide employees with a choice between educational assistance and other remuneration includible in gross income.[40]

### *C. Differences Between Graduate and Undergraduate Students*

The Internal Revenue Code treats graduate students differently than undergraduate students. Sections 117 and 127, as well as tuition reductions, exemplify this point. Certain tuition reductions for graduate students are not excludable from income while the same type of tuition reduction is excludable from an undergraduate student's income. It is "clear that graduate tuition waivers may be excluded under section 117(a) as a 'qualified scholarship,' notwithstanding the limited scope of section 117(d) (under which a 'qualified

33. I.R.C. § 127(a)(1) (2003).

34. "This exclusion does not apply to graduate-level courses." Joint Comm. on Taxation, Overview of Present Law and Issues Relating to Tax and Savings Incentives for Education, JCX-12-99 (Mar. 2, 1999).

35. INTERNAL REVENUE SERVICE, *1990 IRS Exempt Organizations CPE Technical Instruction Program Textbook: Chapter J: Compensation*, TAX NOTES TODAY, Mar. 21, 1994, LEXIS, 94 TNT 54-78 [hereinafter INTERNAL REVENUE SERVICE].

36. I.R.C. § 127(c)(1)(B) (2003).

37. *Id.* § 127(a)(2).

38. *Id.* § 127(a)(1).

39. *Id.* § 127(b)(1).

40. *Id.* § 127(b)(2), (4).

tuition reduction' is limited to education below the graduate level)."[41] While scholarships for graduate students escape taxation, tuition reductions for graduate students do not. This difference is noteworthy because, in many cases, universities grant in-kind tuition assistance as part of a financial aid package offered to attract highly qualified graduate students.[42] "[I]t would be inconsistent with the legislative history and purpose of section 117 to suggest that CASH tuition scholarships to graduate assistants are excludable, but that IN-KIND tuition scholarships are not excludable."[43] Section 117(d) is indicative of Congress's intent to treat graduate and undergraduate students differently.

Further, graduate student scholarships should be treated differently than scholarships for undergraduates because the demographics of the two groups are so different. During the 1999-2000 school year, fifty-seven percent of undergraduate students were traditional students, age 23 or younger.[44] Eighty percent of all undergraduates were employed, approximately half of them full-time and half part-time.[45] A little more than a quarter of undergraduate students had dependents and thirteen percent were single parents.[46] Sixty-one percent of undergraduates were enrolled full time.[47] Students attending two-year public institutions were older than those at four-year institutions and were more likely to have dependents and work full time.[48] Conversely, students attending private four-year institutions were more likely to be of traditional

41. Kathleen Nilles & John Jonas, *Patton, Boggs & Blow Want Treatment of Graduate Tuition Waivers and Payment for 'Future Services' Made Clear*, TAX NOTES TODAY, Aug. 17, 1988, LEXIS, 88 TNT 169-25.

42. *Id.* In-kind scholarships refer to some type of reduction of a student's tuition, i.e. tuition waivers and distributions from a section 529 plan, while cash scholarships refer to those granted by other organizations. In-kind is defined as "[g]iven in goods, commodities, or services rather than money." AMERICAN HERITAGE DICTIONARY OF THE ENGLISH LANGUAGE (4th ed. 2000), *at* http://www.bartleby.com/61/69/I0146900.html (last visited Apr. 13, 2004).

43. Nilles & Jonas, *supra* note 41 (emphasis in original).

44. National Center for Education Statistics (NCES), *Contexts of Postsecondary Education: Characteristics of Postsecondary Students*, *at* http://nces.ed.gov/programs/coe/2003/section5/indicator32.asp (last visited Apr. 13, 2004) [hereinafter NCES, *Contexts*]. A "traditional" undergraduate student is one who earns a high school diploma and immediately enrolls in college full-time, does not work during the school year (or works part time), and depends upon parents for financial support. NCES, *Special Analysis 2002: Nontraditional Undergraduates*, *at* http://nces.ed.gov/programs/coe/2002/analyses/nontraditional/ (last visited Apr. 13, 2004) [hereinafter NCES, *Special Analysis*]. These students are the exception rather than the rule, as just more than a quarter of undergraduates met all of the previously mentioned criteria. *Id.*

45. NCES, *Contexts*, *supra* note 44.

46. *Id.* Twenty-seven percent of undergraduate students had dependents. *Id.*

47. *See* NCES, *Special Analysis*, *supra* note 44.

48. NCES, *Contexts*, *supra* note 44. Enrollment at two-year institutions constituted forty-four percent of undergraduates. NCES, *Special Analysis*, *supra* note 44.

age, attend full time, and not work.[49] Women made up more than half of all undergraduates and almost one third of students were minorities.[50] Approximately ten percent of undergraduates had some type of disability.[51]

Broken down into three groups of students, graduate student demographics for the same year are quite different from undergraduate statistics. These groups consist of Masters, Doctoral, and First-Professional students. For the last twenty-five years, the majority of graduate students have been enrolled part time.[52] Yet, in the same period of time, there has been a seventy-six percent increase in full time enrollment while only a nineteen percent increase in part time enrollment.[53] In the 1999-2000 school year, women made up fifty-eight percent of all graduate students.[54] Sixty percent of Masters students were female with the average age being thirty-two.[55] Sixty-one percent of all students considered themselves employees enrolled in school.[56] Sixty-three percent of those who worked were employed thirty-five hours or more per week.[57] Thirty-six percent of these students were part time students for the full year.[58] Thirty percent of all Masters students delayed returning to school for seven years or more after receiving a bachelor's degree.[59] Therefore, the typical student working toward a Masters in business was male, in his early thirties, with a full-time job; the typical student working toward a Masters in education was female, approximately thirty-two years old, attending school part-time, and holding down a full-time job.[60]

The typical Doctoral student was female, in her early forties, and attending school part time.[61] Thirty-five percent of these students delayed their higher education seven years or more.[62] More than half attended school full time for

49. NCES, *Contexts*, *supra* note 44.

50. *Id.*

51. *Id.*

52. NCES, *The Condition of Education: Participation in Education*, *at* http://nces.ed.gov/programs/coe/2003/section1/indicator07.asp (last visited Apr 13, 2004).

53. *Id.*

54. *Id.*

55. NCES, *Student Financing of Graduate and First-Professional Education 1999-2000: Profiles of Students in Selected Degree Programs and Their Use of Assistantships*, *at* http://nces.ed.gov/pubs2002/2002166.pdf (July 2002) [hereinafter NCES, *Student Financing*].

56. *Id.* Twenty-five percent of all students are working to meet expenses and fourteen percent of students do not work. *Id.*

57. *Id.*

58. *Id.* Twenty-eight percent of students attend school part time for part of the year. *Id.* Twenty-seven percent are full time students for the full year. *Id.*

59. *Id.* Twenty-eight percent of students waited three to six years before returning to school. *Id.*

60. NCES, *Student Financing*, *supra* note 55.

61. *Id.* at 7.

62. *Id*. Approximately a quarter have put off school for three to six years while another quarter wait less than one year to return to school. *Id.*

the full year.[63] Thirty-one percent of Doctoral students were primarily employees who attended school while forty-four percent were primarily students working to meet expenses.[64] Almost forty percent of working Doctoral students spent thirty-five hours or more at their jobs.[65]

The average age of the First-Professional student was twenty-seven, and seventy-seven percent of First-Professional students attended school full time.[66] Only twelve percent waited seven years or more to return to school while forty-two percent delayed less than one year.[67] Forty percent of First-Professional students worked to meet their expenses while only ten percent were primarily employees.[68] Of those students that had jobs, thirteen percent worked thirty-five hours or more per week.[69]

## III. WHY CURRENT TAX CREDITS ARE INSUFFICIENT FOR GRADUATE STUDENTS

### *A. Current Available Tax Credits*

President Bill Clinton signed The Taxpayer Relief Act (TRA) into law on August 5, 1997.[70] The TRA added key sections to the Internal Revenue Code including tax benefits for those who pay education expenses.[71] The tax credits "were intended to reduce the costs of . . . education by passing a portion of its cost along to the federal treasury."[72] "[B]oth the House and Senate made it clear the that the [sic] tax breaks for education were designed to help those most in need of assistance and to encourage saving for education."[73] The tax benefits in the TRA that apply to graduate students include the Lifetime Learning Credit, an allowable deduction for interest paid on student loans, section 222 deductions, penalty-free withdrawals from Individual Retirement

63. *Id.*

64. *Id.*

65. NCES, *Student Financing*, *supra* note 55, at 7.

66. *Id.*

67. *Id.* Thirty percent delay returning to school for one to two years, and sixteen percent wait three to six years. *Id.*

68. *Id.* at 48. Fifty percent of first-professional students do not work at all. *Id.*

69. *Id.*

70. Taxpayer Relief Act of 1997, Pub. L. No. 105-34, 111 Stat. 788 (1997).

71. Cynthia E. Garabedian, *Tax Breaks for Higher Education: Tax Policy or Tax Pandering?*, 18 VA. TAX REV. 217, 220 (1998).

72. Glenn E. Coven, *Bad Drafting: A Case Study of the Design and Implementation of the Income Tax Subsidies for Education*, 54 TAX LAW. 1, 26 (2000).

73. Garabedian, *supra* note 71, at 219.

Accounts (IRA), the creation of Education IRAs, and qualified tuition programs.[74]

1. Lifetime Learning Credit

The Lifetime Learning Credit is a nonrefundable tax credit[75] equal to twenty percent of the first $10,000 the taxpayer spends on qualified tuition and related expenses.[76] Therefore, the maximum amount of credit a taxpayer can receive is $2,000.[77] This credit is only applicable toward "qualified tuition and related expenses"[78] required for the enrollment or attendance of a student at an eligible educational institution for courses at that institution.[79] This credit's availability is not limited to a certain number of years in which it may be claimed.[80] It may be used toward expenses incurred to acquire or improve job skills whether enrollment is full-time, half-time, or less than half-time.[81] "[I]t appears from the face of the statute that the student does not have to carry any minimum course load and does not have to be enrolled in a program leading to a recognized 'credential.'"[82] For example, a taxpayer taking one course per semester in graduate school may use this credit.

The Lifetime Learning Credit is limited by income requirements. Taxpayer eligibility for this credit is determined by the taxpayer's "modified adjusted gross income"[83] calculated by certain ratio formulas.[84] It is phased

74. The Hope Credit was also part of the educational tax benefit package. However it does not benefit graduate students because it is only available during the first two years of a student's education. I.R.C. § 25A(2)(A) (2003).

75. Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 201(a), 111 Stat. 788 (1997).

76. I.R.C. § 25A(c)(1) (2003). Before 2003, the tax credit was only available for up to $5,000 of qualified expenses. *Id.*

77. *Id.*

78. *Id.* § 25A(f)(1). Only the costs of tuition and "fees required for the enrollment or attendance" are eligible. *Id.* § 25A(f)(1)(A). But, as expressly stated in section 25A(f)(1)(C), the term "does not include . . . student activities fees . . . unrelated to an individual's academic course of instruction." Furthermore, the costs of books are not allowable as qualified fees. *See* H.R. REP. NO. 105-220, at 346 (1997), *reprinted in* 1997 U.S.C.C.A.N. 1129, 1158. "Supplies and equipment are not mentioned but presumably are to be treated in the same manner as books. The costs of room and board are clearly excluded." Coven, *supra* note 72, at 36.

79. I.R.C. § 25A(f)(1) (2003).

80. H.R. REP. NO. 105-220 (1997).

81. I.R.C. §§ 25A(f)(2), (c)(2)(b), (b)(3)(b) (2003).

82. Coven, *supra* note 72, at 32.

83. I.R.C. §§ 25A(h)(2), (d) (2003). This amount is normally equal to the taxpayer's adjusted gross income calculated in the normal course of preparing a tax return. I.R.S. Notice 97-60, 1997-46 I.R.B. 8, 9.

84. I.R.C. § 25A(d)(1)-(2) (2003). Subsection (d) requires that the amount of credit that would otherwise be available to the taxpayer under subsection (a) be reduced by the "ratio amount" (not less than zero) that bears the same ratio to this credit amount as the taxpayer's

out for taxpayers with a modified adjusted gross income between $40,000 and $50,000, or between $80,000 and $100,000 for joint-return filers.[85] This credit is also available only on a per taxpayer basis,[86] and is calculated on the basis of the family income rather than the number of individual students in the family.[87] This means that a taxpayer in graduate school with a dependent in college may only take up to $2,000 for this credit.[88]

2. Interest Deduction

In general, personal interest is not deductible under the Internal Revenue Code.[89] Section 162(h)(2) considers personal interest as any interest that is not trade or business interest, investment interest, or home mortgage interest.[90] However, an above-the-line deduction is available for interest that a taxpayer pays on any "qualified education loan"[91] during the tax year.[92] In essence, the "loan must have been used to pay the costs of attendance at an eligible educational institution for a student enrolled at least half-time in a program leading to a degree, certificate, or other recognized educational credential."[93] The premise underlying this deduction is that "many students incur considerable debt in the course of obtaining undergraduate and graduate education. The Committee believe[d] that permitting a deduction for interest on certain student loans will help to ease the financial burden that such

modified gross adjusted income less $40,000 ($80,000 for joint filers) bears to $10,000 ($20,000 for joint filers). This is the formula for the "available credit amount." *Id.*

85. *Id.* §§ 25A(h)(2)(A), (d)(2)(A).

86. *Id.* § 25A(c)(1).

87. I.R.S. Notice 97-60, 1997-46 I.R.B. 8, 11.

88. *See supra* note 77 and accompanying text. This example assumes that the taxpayer's gross income is less than $50,000 per year and would not be phased out by the income levels in I.R.C. § 25A(c)(2)(A) (2003).

89. I.R.C. § 163(h) (2003).

90. *Id.* § 162(h)(2) (2003).

91. Section 221(d)(1) defines "qualified education loan" as any indebtedness incurred solely to pay for qualified education expenses incurred on behalf of the taxpayer or dependents, which are attributable to education provided for an eligible student. Qualified education expenses include tuition, related costs, room, and board, as well as "transportation and miscellaneous expenses of the student." Treas. Reg. § 1.221-1(f)(2)(i) (2003). An eligible student is a student who is enrolled at least half-time and meets the requirements of section 484(a)(1) of the Higher Education Act of 1965, 20 U.S.C. 101(a)(1). A qualified education loan does not include indebtedness owed to a relative or under a qualified employer plan. I.R.C. § 221(d) (2003).

92. I.R.C. §§ 221(a), 62(a)(17) (2003). The amount of a loan must be reduced by the amount of any scholarship. *Id.* § 221(d)(2)(b).

93. I.R.S. Notice 97-60, 1997-46 I.R.B. 8, 15. "Eligible educational institution" covers almost all accredited public, nonprofit, and propriety post-secondary institutions, as well as those that conduct internships or residency programs that lead to a degree or certificate from a hospital or higher education institution. *Id.*

obligations represent."[94] This deduction targets relieving graduates who are starting careers and families.[95]

This deduction can be taken for loans whether they are federal or privately subsidized.[96] The current maximum deduction is $2,500 per taxable year.[97] However, this deduction begins to phase out for taxpayers with a modified adjusted gross income of $50,000 ($100,000 for joint filers).[98] This deduction is not available to anyone who is claimed as a dependent on another taxpayer's return.[99] The interest deduction is only available to married taxpayers if a joint return is filed for the particular tax year.[100] The taxpayer can take the deduction regardless of whether his return is itemized or whether he has taken the standard deduction.[101]

3. Section 222 Deductions

Under section 222(a) of the Internal Revenue Code, individuals are allowed to deduct an "amount equal to qualified tuition and related expenses paid by the taxpayer during the taxable year."[102] The deduction allowance cannot exceed the applicable dollar limit.[103] For the tax years of 2002 and 2003, the applicable dollar limit is equal to $3,000 for taxpayers whose adjusted gross income does not exceed $65,000, or $130,000 in the case of a joint return.[104] Hence, taxpayers whose adjusted gross income is greater than the applicable limit are not allowed to take this deduction.[105] For the tax years of 2004 and 2005, the applicable dollar amount is $4,000 for taxpayers whose adjusted gross income does not exceed $65,000, or $130,000 in the case of a joint return.[106] For taxpayers whose adjusted gross income does not exceed $80,000, or $160,000 in the case of a joint return, the applicable dollar amount is $2,000.[107] Consequently, taxpayers whose gross income is greater than

94. S. REP. NO. 105-33, at 20 (1997).
95. Albus, *supra* note 5, at 612.
96. I.R.S. Notice 97-60, 1997-46 I.R.B. 8, 15-16.
97. I.R.C. § 221(b)(1) (2003).
98. *Id.* § 221(b).
99. *Id.* § 221(c).
100. *Id.* § 221(e)(2).
101. Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 202(e), 111 Stat. 788, 809 (1997).
102. I.R.C. § 222(a) (2003). For qualified tuition and expenses, see also Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 25A(b)(1)(A), 111 Stat. 788, 799 (1997).
103. I.R.C. § 222(b)(1) (2003).
104. *Id.* § 222(b)(2)(A)(i).
105. *Id.* § 222(b)(2)(A)(ii).
106. *Id.* § 222(b)(2)(B)(i).
107. *Id.* § 222(b)(2(B)(ii).

$80,000, or $160,000 in the case of a joint return, are afforded no deduction.[108] After the tax year of 2005, this deduction is no longer allowed.[109]

"No deduction shall be allowed under subsection (a) for any expense for which a deduction is allowed to the taxpayer under any other provisions of this chapter."[110] The taxpayer must choose whether to use this deduction for the qualified tuition and related expenses of the student or for the education credits in section 25A.[111] The taxpayer cannot use both the educational credits and the deduction under this section. The total amount of tuition and related expenses should be reduced by the amount of such expenses taken into account in determining the amount excluded under sections 135, 529(c)(1), or 530(d)(2).[112] No deduction is allowable for an individual who can be claimed as a dependent or personal exemption on another's tax return for the year.[113]

4. IRA Withdrawals

Taxpayers are allowed to make penalty-free, early withdrawals from IRAs as long as the money is used for higher education expenses.[114] The expenses may be for the taxpayer, the taxpayer's spouse, or any child or grandchild of the taxpayer or taxpayer's spouse.[115] Qualified expenses include "tuition, fees, books, supplies, and equipment required for the enrollment or attendance of the student at an eligible educational institution."[116] Room and board may also be included in eligible expenses if the student is enrolled at least half-time.[117]

Congress considered penalty-free withdrawals "appropriate and important" when the funds are used for the purpose of paying higher education expenses.[118] Federal income tax will be owed on the amount withdrawn, but "will not be subject to the 10 percent early withdrawal tax that applies when amounts are withdrawn from an individual retirement account before the account holder reaches age 59 ½."[119]

108. I.R.C. § 222(b)(2)(B)(iii) (2003).
109. *Id.* § 222(e).
110. *Id.* § 222(c)(1).
111. *Id.* § 222(c)(2)(A). Education Credits refer to the Lifetime Learning Credit and the Hope Credit.
112. *Id.* § 222(c)(2)(B).
113. I.R.C. § 222(c)(3) (2003).
114. *Id.* §§ 72(t)(2)(E), (t)(7) (2003).
115. *Id*. § 72(t)(7)(A).
116. I.R.S. Notice 97-60, 1997-46 I.R.B. 15.
117. *Id*.
118. H.R. REP. NO. 105-148, at 330 (1997), *reprinted in* 1997 U.S.C.C.A.N. 678, 724.
119. I.R.S. Notice 97-60, 1997-46 I.R.B. 15.

5. Education IRA

Section 530(a) of the Internal Revenue Code provides for an Education Individual Retirement Account ("Education IRA"), also referred to as a Coverdell education savings account, which is exempt from taxation.[120] The Education IRA is a trust with the purpose of "paying the qualified education expenses of an individual who is the designated beneficiary of the trust."[121] The purpose of this IRA was to "encourage families and students to save for future education expenses."[122] Contributions toward this IRA must be in cash, made before the beneficiary turns eighteen, and must not exceed $2,000 per taxable year.[123] The maximum contribution is phased out for contributors with modified adjusted gross incomes between $95,000 and $110,000, or $190,000 and $205,000 for joint filers.[124] Taxpayers with a modified adjusted gross income of $110,000 or greater, or $205,000 or greater for joint filers, may not make contributions. Contributions are allowable from any person, including parents, grandparents, friends, and the beneficiary, subject to the limitations on the maximum contribution and modified adjusted gross income.[125]

Generally, any distributions from the trust are taxable.[126] However, if the beneficiary's qualified higher education expenses[127] are equal to, or exceed the total distributions for the year, they are not taxable.[128] If the distributions exceed the education expenses during the taxable year, the excess amount of distributions to the beneficiary is subject to being taxed.[129] An additional ten percent is added to the tax on excess distributions.[130] If contributions exceed the maximum amount allowed, they will be subject to federal income tax if withdrawn in the same year, but the additional ten percent tax will not.[131]

120. I.R.C. § 530(a). However, the Education IRA is subject to taxes imposed by I.R.C. § 511 (2003), which relates to the imposition of taxes on unrelated business income of charitable organizations.

121. *Id.* § 530(b)(1).

122. H. REP. NO. 105-148, at 323 (1997), *reprinted in* 1997 U.S.C.C.A.N. 678, 717.

123. I.R.C. § 530(b)(1)(A) (2003).

124. *Id.* § 530(c).

125. I.R.S. Notice 97-60, 1997-46 I.R.B. 12.

126. I.R.C. § 530(d)(1) (2003).

127. Qualified education expenses include tuition, fees, books, supplies, and equipment required for enrollment of a designated beneficiary at an eligible educational institution. *Id.* §§ 530(b)(4)(A)(i), 529(e)(3). The total amount of qualified education expenses must be reduced by scholarships, or any other educational assistance when taken in conjunction with the Hope and Lifetime Learning Credits. *Id.* § 530(d)(2)(C)(ii).

128. *Id.* § 530(d)(2)(A).

129. *Id.* § 530(d)(2)(B).

130. *Id.* § 530(d)(4)(A).

131. I.R.C. § 530(d)(4)(C) (2003). But if the excess contribution remains in the IRA that year, the amount will be subject to a six percent excise tax for each year the amount remains in the IRA. I.R.S. Notice 97-60, 1997-46 I.R.B. 13.

Funds from other rolled over education IRAs are not subject to the federal income tax at the time of distribution.[132] If the beneficiary has not used all of the funds by thirty years of age, the funds will be distributed to the beneficiary and taxed appropriately.[133]

6. Qualified State Tuition Programs

"Section 529 (enacted as part of the Small Business Job Protection Act of 1996) provides tax-exempt status to 'qualified State tuition programs.'"[134] A qualified tuition program is one that is established and maintained by a state, or an agency or instrumentality thereof, or by one or more eligible institutions, under which a person may: (1) purchase tuition credits or certificates on behalf of a designated beneficiary to be used as a waiver or payment of qualified higher education expenses of the beneficiary, or, (2) make contributions to an account established for the purpose of meeting the qualified higher education expenses of the designated beneficiary of the account.[135] The qualified tuition program must provide separate accounting for each designated beneficiary, and contributions may only be made in cash.[136] It must also provide that contributors or beneficiaries may not directly or indirectly control the investment of contributions, or use any interest in the program as security for a loan.[137] The tuition program must also provide adequate safeguards to prevent contributions in excess of those necessary to provide for the education expenses of the beneficiary.[138]

No portion of the distribution or earnings under the program is includible in the gross income of a designated beneficiary or a contributor to the program.[139] However, amounts distributed or educational benefits provided to a beneficiary are included in the beneficiary's gross income to the extent such amounts or value of the educational benefits exceed the contributions.[140] Amounts distributed to a contributor shall be included in the contributor's gross income if those amounts exceed the contributions made by that person.[141] The total amount of qualified education expenses should be reduced by the

132. I.R.C. § 530(d)(5) (2003). The rollover amount must be received from another Coverdell account for the benefit of the same beneficiary or a member of the family. *Id.*

133. *Id.* § 530(b)(1)(E).

134. STAFF OF JOINT COMM. ON TAXATION, 105TH CONG., ANALYSIS OF PROPOSED TAX AND SAVINGS INCENTIVES FOR HIGHER EDUCATION 4 (Comm. Print 1997).

135. I.R.C. § 529(b)(1)(A) (2003).

136. *Id.* § 529(b)(2), (3).

137. *Id.* § 529(b)(4), (5).

138. *Id.* § 529(b)(6).

139. *Id.* § 529(c)(1).

140. *See supra* note 128 and accompanying text.

141. STAFF OF JOINT COMM. ON TAXATION, 105TH CONG., ANALYSIS OF PROPOSED TAX AND SAVINGS INCENTIVES FOR HIGHER EDUCATION 4-5 (Comm. Print 1997).

amount that was taken into account in determining the Hope or Lifetime Learning credits under section 25A.[142]

### *B. Why Tax Credits are Insufficient for Graduate Students.*

#### 1. Lifetime Learning Credit

"Lower-income taxpayers derive significantly less benefit from the . . . Lifetime Learning credits than middle and higher-income taxpayers."[143] Lower-income taxpayers do not necessarily have the requisite tax liability to benefit from this credit.[144] Thus, if the taxpayer does not owe enough in taxes for the year, this credit will not provide a benefit. So, even qualified taxpayers may not benefit from this credit immediately because they may not receive the tax relief until after the education expenses have been paid.[145] Additionally, many taxpayers do not have the financial means to pay for the education expenses upfront and must wait until their tax return is filed to receive relief.

Another problem with this credit is that the monetary limit is not set high enough to make much of a difference for many taxpayers. Most graduate programs cost considerably more than $10,000 a year to attend full time.[146] Because the taxpayers can only take twenty percent of the first $10,000 in tuition,[147] the taxpayers receive only a minute fraction of education expenses as a credit. Therefore, this credit provides a minimal benefit to taxpayers.

Additionally, this credit might actually end up causing tuition rates to rise because "colleges may determine that the credits provide taxpayers with an ability to pay more."[148] Educational institutions might view these credits as an increase in income and might award less need-based financial aid,[149] making it more difficult for students to afford an education. The income phase-out levels are relatively low as well.[150] If a taxpayer attends graduate school part time while working full time, he may not be eligible for this credit if his income is

142. I.R.C. § 529(c)(3)(B)(v) (2003).

143. Mulleneaux, *supra* note 12, at 36.

144. *Id*.

145. *Id.*

146. *See infra* note 194 and accompanying text.

147. Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 201(c)(1), 111 Stat. 788, 800-01 (1997).

148. Mulleneaux, *supra* note 12, at 37.

149. *See Education and Training Tax Provisions of the Administration's Fiscal Year 1998 Budget Proposal: Hearing Before the House Comm. on Ways and Means*, 105th Cong. (1997).

150. *See* I.R.C. § 25A(d)(1), (2) (2003). Subsection (d) requires that the amount of credit that would otherwise be available to the taxpayer under subsection (a) be reduced by the "ratio amount," not less than zero, that bears the same ratio to this credit amount as the taxpayer's modified gross adjusted income less $40,000, or $80,000 for joint filers, bears to $10,000, or $20,000 for joint filers. This is the formula for the "available credit amount." *Id.*

greater than $50,000.[151] This scenario is unfair if the taxpayer is raising a family at the same time.

This credit is more beneficial to graduate students who are carrying a part-time load of classes or less. Because tuition is high at educational institutions, the student with a part time load receives a greater tax benefit because he is receiving a credit for a greater portion of the money paid to the institution. Along the same line, a taxpayer with no dependents will receive a greater portion of his money back because this credit is considered on a per taxpayer basis, as opposed to a per student basis. [152] For example, a taxpayer attending graduate school part time with a dependent who is in the third or fourth year of college will not receive the Lifetime Learning Credit for both students.[153] Most likely, this credit will be phased out with the cost of the dependent's tuition, so there is no tax incentive for the taxpayer to return to school.

The last problem with the Lifetime Learning Credit is that not all educational expenses are included. Many educational institutions require that students pay certain fees for enrollment, but section 25A(f)(1)(C) does not allow such fees to be included if they are "unrelated to an individual's academic course of instruction."[154] This could be interpreted as meaning that if the fee is not directly related to the student's major, then it is not includable. Books that are required for courses are not allowable as qualified fees either.[155] Books are no small expense; they can cost upwards of $1,000 a year and should be included because they are necessary for students to participate in class work.

2. Interest Deduction

The allowable interest deduction on qualified educational loans is not beneficial for students who borrowed money to attend graduate school. The first problem is that the deduction phases out at income levels that are too low to be beneficial for many students with graduate degrees.[156] The deduction begins to phase out at $50,000 of income for individual taxpayers and $100,000 for joint filers.[157] One of the reasons students return to school for a graduate degree is that, hopefully, it will aid them in obtaining a greater income. Congress seems to be sending the message that those with incomes above the phase-out levels do not need the benefit of this deduction.[158]

151. *Id.*
152. *Id.* § 25A(c)(1).
153. The dependent would be ineligible for the Hope Credit.
154. I.R.C. § 25A(f)(1)(c) (2003).
155. *See* H.R. CONF. REP. NO. 105-220, at 346 (1997), *reprinted in* 1997 U.S.C.C.A.N. 1129, 1158.
156. Albus, *supra* note 5, at 613.
157. I.R.C. § 221(b)(2) (2003).
158. Albus, *supra* note 5, at 613.

Students might be discouraged knowing that when they graduate, this deduction will not apply to them if they find a job that will pay more than the phase-out levels.[159] Therefore, this provision could actually be an incentive to get a lower-paying job, so that an individual could take the deduction.[160] This deduction will not be beneficial to many graduate students because their income levels will most likely be above the phase-out level simply because they have an advanced degree.[161] Therefore, in reality, there is no interest deduction benefit to taxpayers with graduate school debt.

For those individuals who are not phased out of the deduction by income levels, the interest deduction on loans is still not sufficient. The maximum deduction a taxpayer can take in any taxable year is $2,500.[162] This might seem like a generous amount, but the taxpayer can still run into problems. A taxpayer might have combined undergraduate and graduate loans that have interest in excess of that amount. Even though graduate students generally obtain higher paying jobs upon graduation, their debt burden is also considerably higher than those without graduate degrees.[163] As a result, those who are paying back graduate degree loans struggle just as much as those who are only paying back undergraduate loans.[164] The current $2,500 limit is too low to provide relief for those paying off graduate student loans.

3. Section 222 Deductions

This deduction is insufficient for graduate students because it can only affect those students who use an itemized deduction rather than the standard deduction and whose incomes are high enough to be paying taxes. Realistically, this implies that only those students who are older and own homes can take advantage of this deduction because most taxpayers who do not own homes cannot qualify for itemized deductions. However, the deduction is not very helpful to students who make little or no money because they do not have tax liability.

Even for those who can take advantage of the deduction, the dollar limit is very low. The applicable dollar limits are anywhere from $2,000 to $4,000, depending on the tax year.[165] Graduate school is obviously more expensive than the dollar limits allow, so this benefit is minimal.[166] A big drawback to this deduction is that a student cannot claim it and still take advantage of the

159. *Id.* at 614.
160. *Id.* at 613.
161. *See id.* at 615.
162. I.R.C. § 221(b)(1) (2003).
163. Albus, *supra* note 5, at 615.
164. *Id*.
165. I.R.C. § 222(b)(2) (2003).
166. *See generally infra* note 237 and accompanying text.

Lifetime Learning or Hope Credits in the same year.[167] The average student is better off taking a credit rather than a deduction because a credit directly reduces the amount of taxes due while the deduction only reduces adjusted gross income. Finally, this deduction is scheduled to expire in 2005, so the benefit will be extinguished soon.[168]

4. IRA Withdrawals

Penalty-free IRA withdrawals are the least effective education tax break for low-income taxpayers. First, low-income families might not even have IRAs from which to make withdrawals.[169] If the taxpayer does have an IRA, there might not be enough money in it to cover the education expenses. It is more likely that the taxpayer cannot afford to withdraw money from his retirement fund to pay for education expenses. Therefore, in reality, this tax break is only applicable to middle-income or wealthy taxpayers. However, regardless of the taxpayer's income, the money that is withdrawn is still taxed at the federal income rate.[170] Even if a low-income person wanted to withdraw money from his IRA to pay for his education, he would then be taxed as if that amount were part of his normal income. For this same reason, the penalty-free withdrawals are insufficient for middle-income and wealthy taxpayers too.

5. Education IRAs

Education IRAs are insufficient for graduate students because few taxpayers are able to use those funds toward graduate school. The funds in the IRA must be used by the time the beneficiary is thirty years of age or the money will be distributed in a lump sum to the beneficiary when he attains the age of thirty.[171] This provision eliminates the opportunity for taxpayers who are returning to school after the age of thirty from using this type of IRA.[172] Another problem for graduate students is that the contributions must have been made before the beneficiary turns eighteen years of age. The only way a student who wanted to use the funds for graduate school could do so is if the trust had leftover money from when the student went to college. Another similar problem is that because the contribution limit per year is $2,000,[173] there would most likely be no funds left for graduate school after an undergraduate degree had been obtained. Even if contributions of $2,000 per year had been made for eighteen years, approximately $36,000 would be used

167. *See supra* note 111 and accompanying text.
168. I.R.C. § 222(e) (2003).
169. Garabedian, *supra* note 71, at 234.
170. I.R.S. Notice 97-60, 1997-46 C.B. 310.
171. I.R.C. § 530(b)(1)(E) (2003).
172. *See generally supra* note 133 and accompanying text.
173. I.R.C. § 530 (b)(1)(A) (2003).

for an undergraduate education. Also, if more than the $2,000 limit per year was contributed in order to have enough money later for a graduate degree, the amount over $2,000 would be penalized by a ten percent tax.[174]

Once again, this tax break for education would probably not be beneficial to low-income taxpayers. Low-income families would probably not have the disposable income to create Education IRAs,[175] much less the income to contribute the maximum amount every year.

6. Qualified State Tuition Programs

Qualified state tuition programs are not helpful to graduate students in most instances. One of the drawbacks of using a qualified state program is that the amount of education expenses used toward determining the Lifetime Learning Credit reduces the qualified expenses allowable under these programs. Therefore, the taxpayer cannot use both the Lifetime Learning Credit and the state tuition programs to the same extent as he could if he were to only use one. Another reason that the qualified state tuition program leaves the non-scholarship graduate student at a tax disadvantage is that the cash contributions to the account are made with after-tax funds. Once again, the contributor to the fund has already paid federal and state taxes on that income so the contributions would already have been taxed.

## IV. ANALYSIS

After reviewing why non-scholarship graduate students are at an economic disadvantage compared to those with scholarships, this section will discuss whether a tax on scholarships would alleviate some of the previously discussed disadvantages, and will explore alternatives that might remove unnecessary tax burdens on today's graduate students.

### *A. The Importance of Higher Education in Today's Society*

Higher education has become a necessity for individuals in today's society. "The bachelor's degree has effectively replaced the high school diploma as a requisite to successfully enter the job market."[176] Individuals need a higher education level today simply to achieve the same level of success that one might have attained twenty or thirty years ago with a high school diploma. If, in fact, the bachelor's degree has replaced the high school diploma, then a graduate degree now carries the same weight that the bachelor's degree once did. Because a higher percentage of white-collar workers have a bachelor's

174. *Id.* § 530 (d)(4)(A).
175. Garabedian, *supra* note 71, at 234.
176. Amy J. Oliver, *Improving the Tax Code to Provide Meaningful and Effective Tax Incentives for Higher Education*, 12 U. FLA. J.L. & PUB. POL'Y 91, 93 (2000).

degree, a graduate degree is necessary to attain higher-level jobs or careers.[177] Education is "the key to higher wages and a better standard of living."[178] For example, individuals with at least a bachelor's degree have higher median incomes than those with less education in the age group of twenty-five to thirty-four.[179] More than fourteen million students have enrolled annually in post-secondary education or training programs since 1990.[180] The number of jobs that require a Master's, Bachelor's, or Associate's degree is expected to rise by twenty-five percent according to the Department of Labor.[181]

In addition to individuals' need for higher education opportunities, society benefits when individuals have higher levels of education. A workforce that has obtained advanced degrees is beneficial to the society as a whole. The nation's long-term economic growth depends on broad access to higher education.[182] "[T]he federal government encourages and specifically assists educational activities that are considered in the national interest."[183] There is a national interest in promoting and financially assisting higher education because higher education increases the prosperity of individuals. This, in turn, increases the nation's productivity and wealth as well as assists social progress.[184] The economy has also benefited from higher education because

177. In today's society, higher education is required for most jobs that are not unskilled or entry level positions and might be a prerequisite for certain careers (for example, medicine, law, and architecture). Loretta Collins Argrett, *Tax Treatment of Higher Education Expenditures: An Unfair Investment Disincentive*, 41 SYRACUSE L. REV. 621, 636 (1990).

178. Albus, *supra* note 5, at 601 (quoting 143 CONG. REC. H6623-04, H6655 (daily ed. July 31, 1997)) (statement of Rep. Kolbe). "Education is an investment in one's own human capital." Phillips & Hatfield, *supra* note 4, at 288. Higher education can provide individuals with greater earning power as well as a sense of personal enrichment. *Id*. at 288. Many people believe that the principle reason students incur student loan debt is to further their ability to increase their earning power. Argrett, *supra* note 177, at 636.

179. NCES, *Learner Outcomes: Economic Outcomes*, *at* http://nces.ed.gov/programs/coe/2002/section2/indicator16.asp (last visited Apr. 8, 2004).

180. STAFF OF THE JOINT COMM. ON TAXATION, 106TH CONG., OVERVIEW OF PRESENT LAW AND ISSUES RELATING TO TAX AND SAVINGS INCENTIVES FOR EDUCATION (Comm. Print 1999). Graduate enrollment has increased during the past twenty-five years and is projected to continue to increase. Graduate enrollment is projected to increase to more than two million and first-professional enrollment to 350,000 by 2012. NCES, *Participation in Education: Graduate & Professional Education*, *at* http://nces.ed.gov/programs/coe/2003/section1/indicator07.asp (last visited Apr. 8, 2004).

181. *Education and Training Tax Provisions of the Administration's Fiscal Year 1998 Budget Proposal: Hearing Before the House Comm. on Ways and Means*, 105th Cong. 109 (1997) (statement of Stanley O. Ikenberry, President, American Council on Education).

182. Mulleneaux, *supra* note 12, at 27.

183. *Id.* at 28.

184. *Id.* at 28-29. Higher education leads to better health, and better health is directly related to an individual's income, which in turn increases national growth. *See* NCES, *Learner Outcomes: Social and Cultural Outcomes*, *at* http://nces.ed.gov/programs/coe/2002/section2/indicator14.asp (last visited Apr. 8, 2004). In a 1997 survey those who had higher levels of

advances in knowledge provided more than fifty percent of growth in the United States' wealth in the Twentieth Century.[185] Commentators argue that "education promotes innovation and that, because ideas and innovations are easily copied in the market place, the market return (wage or profit) from ideas and innovations may not reflect the full value to society from the idea or innovation."[186] "[T]he U.S. needs a well-trained and educated workforce to continue to compete in the global marketplace."[187] Additionally, individuals who have some college education contribute more to society than those who do not by participating in volunteer activities and the voting process.[188] Another positive result of higher education is a reduction in crime.[189]

The nation also receives increased tax revenues because of education. Individuals with bachelor's degrees only make up twenty-three percent of tax filers, yet earn forty-three percent of all federal personal income taxes.[190] The labor market is stabilized with higher levels of education for the workforce because it decreases unemployment and job turnover, which also leads to less dependence on public assistance programs.[191] Overall, a higher-educated population benefits society by making individuals more prosperous, stabilizing the economy, creating wealth for the national government, and heightening individuals' interests in societal concerns.

### *B. Cost of Education*

The problem with obtaining advanced degrees is that, often, they are financially, personally, and socially expensive. The cost of obtaining a graduate degree has risen dramatically at a time when higher education is more important than ever, for the reasons stated previously as well as because individuals are seeking fulfilling and rewarding employment.[192] The costs of attending a two- or four-year college have risen faster than the inflation rate every year since 1981.[193] The average tuition cost of a year in graduate school

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education also reported being in "excellent" or "very good" health (independent of income). *Id.* Individuals with a bachelor's degree or higher reported they were in "excellent" or "very good" health twice as much as those who did not have the equivalent of a high school diploma. *Id.* In the same study, the higher family income an individual had, the more likely he or she was to report being in "excellent" or "very good" health. *Id.*

185. Mulleneaux, *supra* note 12, at 29.

186. STAFF OF THE JOINT COMM. ON TAXATION, 106TH CONG., OVERVIEW OF PRESENT LAW AND ISSUES RELATING TO TAX AND SAVINGS INCENTIVES FOR EDUCATION (Comm. Print 1999).

187. Mulleneaux, *supra* note 12, at 29. *See also* Argrett, *supra* note 177, at 624.

188. Mulleneaux, *supra* note 12, at 29-30.

189. Oliver, *supra* note 176, at 98.

190. Mulleneaux, *supra* note 12, at 29.

191. Oliver, *supra* note 176, at 98.

192. Albus, *supra* note 5, at 602.

193. STAFF OF THE JOINT COMM. ON TAXATION, 106TH CONG., OVERVIEW OF PRESENT LAW AND ISSUES RELATING TO TAX AND SAVINGS INCENTIVES FOR EDUCATION (Comm. Print 1999).

for the 2001-2002 school year was approaching $18,000.[194] Congress is aware that most students acquire considerable debt while obtaining undergraduate and graduate degrees.[195] For the 1999-2000 school year, approximately fifty-four percent of full-time graduate students received an average of $16,728 in loans.[196] In 2000, 1,850,000 students were enrolled either full-time or part-time in graduate school.[197]

The large cost of tuition for graduate programs affects a student's personal life in many ways. Students make expenditures on their education by scholarships, direct payment of educational expenses, and forgone wages.[198] When financing a graduate degree through loans, which more than fifty percent of students do,[199] these staggering amounts can have an impact on an individual's life beyond the few years they are in school. The debt that an individual can accrue during school will affect one's financial well-being and choices for as many years as it takes to repay the loans.[200] Student loan debt might force individuals to delay buying a house, having children, or taking a lower-paying job where they might find greater personal satisfaction. Prospective students also must consider whether to invest in higher education or make an alternative investment.[201]

Another impact of the high tuition cost is that "increasing numbers of graduate students must work on a part-time or full-time basis to finance their continued education."[202] Because many students must work while they are in school, they are spending less time on schoolwork and getting less out of their education in the long run.

Not only can very few afford to attend graduate school, but there also are opportunity costs associated with obtaining an advanced degree for those who

194. *See generally* NCES, *Digest of Education Statistics, 2002*: *Table 315*, *at* http://nces.ed.gov/programs/digest/d02/tables/dt315.asp (last visited Apr. 8, 2004) [hereinafter NCES, *Table 315*].

195. S. REP. NO. 105-33, at 20 (1997). The major types of federal financial aid for undergraduate and graduate students are grants and loans. NCES, *Societal Support for Learning: Financing for Postsecondary Education*, *at* http://nces.ed.gov/programs/coe/2003/section6/indicator42.asp (last visited Apr. 8, 2004). However, typically grants are only available to undergraduates and loans are available to both undergraduate and graduate students. *Id.*

196. Choy & Geis, *supra* note 4.

197. National Center for Education Statistics (NCES), *Digest of Education Statistics, 2002: Table 188: Total Graduate Fall Enrollment in Degree Granting Institutions*, *at* http://nces.ed.gov/programs/digest/d02/tables/dt188.asp (last visited Apr. 8, 2004).

198. STAFF OF THE JOINT COMM. ON TAXATION, 106TH CONG., OVERVIEW OF PRESENT LAW AND ISSUES RELATING TO TAX AND SAVINGS INCENTIVES FOR EDUCATION (Comm. Print 1999).

199. Choy & Geis, *supra* note 4.

200. Graduates might have a difficult time just making ends meet when their monthly loan payment is added to the expenses of food, clothing, housing, and transportation that everyone has to meet. Phillips & Hatfield, *supra* note 4, at 254.

201. Argrett, *supra* note 177, at 636.

202. Nilles & Jonas, *supra* note 41.

decide to return to school. Many students give up a job or spend less time at their current job in order to attend school. This results in lost wages as well as lost opportunities for raises, bonuses, and promotions. The forgone income is viewed as if the student worked, was paid, and then purchased his education with the wages.[203] "Analysts have concluded that the largest cost of obtaining an education come[s] from forgone wages."[204] Another opportunity cost for some students is less time to spend with their families, especially if the student has to get a job or work longer hours at a current job in order to pay for their education.

Because of the cost, there are few financial incentives for students to return to school to obtain an advanced degree. One of these incentives is a scholarship. However, those students who do not receive scholarships are forced to pay out of their pockets or to take out loans. "Taxpayers who cannot borrow to finance education . . . may forgo the education or training even though it would produce a high return for the investor."[205] Students who cannot afford to pay out of pocket tuition costs and who cannot or will not take out loans are therefore discouraged from returning to school for an advanced degree.

There is a societal cost resulting from the high tuition rates as well. The public service sector suffers from the high cost of obtaining an advanced degree as well as the staggering debt that many students face when school is finished. The more that students have to pay for their education, whether while in school or repaying loans, the less likely it is that they are able to afford to take low-paying public service jobs.[206] Students are forced into taking the highest-paying job they can get in order to pay for the cost of their graduate degree.[207] This hurts society in the long run because people are less likely to work in public service careers, a sector that cannot afford to hire individuals at the same rate as the private sector. Feasibly, this could lead to a shortage of public services and decreased benefits to the public.

203. *Id.*

204. *Id.*

205. *Id.*

206. The large amount of student loan debt prevents students from taking job opportunities in public interest organizations, in government, and in smaller firms even if the student otherwise would have been willing to take a lower paying job. Phillips & Hatfield, *supra* note 4, at 254. These organizations normally cannot afford or do not provide a salary that would be sufficient to support an individual with large amounts of debt. *Id*. at 257.

207. *Id.* at 254. Unless someone else, such as a family member, is willing or able to afford to make the graduate's monthly student loan payment, a graduate with large student loan debt must seek the highest paying employment available. *Id*. at 255.

### *C. Graduate Student Scholarships Should be Taxed as Gross Income*

According to section 61 of the Internal Revenue Code, gross income is "all income from whatever source derived."[208] A scholarship is undeniably a form of income to a student.[209] Because of public policy reasons, however, Congress exempted scholarships from taxation in section 117.[210] This is understandable for students working toward an undergraduate degree because a bachelor's degree is becoming more of a necessity in today's society.[211]

#### 1. Policy Reasons to Include Scholarships in Graduate Students' Gross Income

For policy reasons, scholarships should be included in the gross income of a graduate student as this would equalize the current inequity in the tax system. Because scholarships are not taxed, graduate students with scholarships receive an unfair tax advantage over those without scholarships. A student without a scholarship ends up paying more for his education because he must pay with after-tax dollars. He either has already paid income taxes on the out of pocket money he uses to pay tuition or pays taxes on the money he earns while paying back school loans. The student with a scholarship, however, does not pay as much in taxes on his education because the money he receives to fund his education is the nontaxable scholarship money. The tax difference might be enough to discourage those without scholarships from pursuing a graduate degree. One of the goals of our tax system is to spread taxes in equal proportions,[212] but this goal is not met where one group of students has a definite tax advantage over another group.

It makes financial sense to require graduate students to include scholarships in their gross income. Taxing the scholarships of graduate students would be a good source of tax income for the government.[213] The tax system is a progressive tax system where the tax burden is spread evenly among the income levels, but wealthier individuals obviously shoulder more of the burden. Requiring graduate students to include scholarships in their income would be in line with the idea behind the progressive system. Once these students have a graduate degree, they will most likely earn more than those with a bachelor's degree. Because graduate students' incomes are likely

208. I.R.C. § 61(a) (2003).

209. Some commentators have criticized the scholarship exemption because scholarships represent an accrual of wealth as much as any other payment. Charlotte Crane, *Scholarships and the Federal Income Tax Base*, 28 HARV. J. ON LEGIS. 63, 65 (1991).

210. *See id.* at 103.

211. *See supra* note 176 and accompanying text.

212. *See supra* note 5 and accompanying text.

213. A scholarship exemption for graduate students poses a substantially greater threat to the revenue base than an exemption for undergraduate scholarships. Crane, *supra* note 209, at 106.

to be higher, they are the group of people that most likely can afford to pay a tax on scholarships.

2. Tax Code Inconsistencies in What Type of Income Graduate Students Must Include

The tax code treats income of graduate students inconsistently in a few situations. The code should treat all income for the purpose of education the same and require it to be included in a student's gross income.

Section 117(c) says that any portion of a scholarship that represents payment for services by the student, required as a condition to acceptance of the scholarship, is includible in gross income.[214] However, if it is not already spelled out in the terms of the scholarship agreement, implicit in most scholarship grants is the duty of the student to attain a certain grade point average. For example, to keep a scholarship from one semester to the next or even from one year to the next, students often must maintain a high grade point average.[215] This is the equivalent of requiring the student to do something in order to receive the scholarship. The student must work for his grades and so the scholarship resembles a payment for achieving high grades. The same can be said for scholarships that require the student to participate in community service.[216] The scholarship that requires a student to perform community work essentially represents a payment to a student for services. Therefore, graduate student scholarships that require conditional grade point averages or community service should be taxed because those are conditions to payment of the scholarship.[217]

There is an inconsistency as to how the tax code treats income in the form of tuition reductions and scholarships for graduate students. A tuition

214. I.R.C. § 117(c)(1) (2003).

215. For example, the University of Louisville requires students to maintain at least a 3.0 cumulative grade point average to keep scholarships from one year to the next. University of Louisville, *Trustee Scholarship Requirements and Expectations*, *at* http://www.louisville.edu/student/services/fin-aid/scholar/trusteeexpect.html (last updated Mar. 6, 2003). *See also* Saint Louis University, *University Scholarship/Financial Aid Programs*, *at* http://www.slu.edu/services/registrar/pdf_2002/scholarship_and_financial_aid.pdf (last visited Apr. 8, 2004). *See also* Washington University in St. Louis Office of Student Financial Services, *Frequently Asked Questions*, *at* http://aisweb.wustl.edu/sfs/newsfshome.nsf/pages/p_faq (last visited Apr. 8, 2004).

216. *See generally* Saint Louis University, *supra* note 215.

217. One argument is that the services required must be for the benefit of the grantor. *See supra* note 21 ("A requirement that the recipient pursue studies, research, or other activities primarily for the benefit of the grantor is treated as a requirement to perform services."). However, section 117 does not make this distinction. Even so, students required to work for a higher grade point average or to perform community service are benefiting the university; because the students perform community service in the university's name, it receives public relations benefits. The university also is able to attract more students when the average student grade point average is higher.

reduction can be viewed as the educational organization giving the money to the student who then turns around and pays the tuition with the money, which is very similar to a scholarship. The effect of scholarships and tuition reductions are the same—the student is responsible for less tuition. A graduate student is not allowed to exclude a reduction in tuition from his gross income if he is an employee and a student of an educational institution.[218] A tuition reduction is excludable, however, if the student is taking classes below the graduate level.[219] Additionally, graduate students engaged in teaching or research activities for an educational organization are allowed to exclude the tuition reduction even though they may be considered an employee.[220]

The inconsistency is that graduate students are currently allowed to exclude qualified scholarships from gross income, but one who receives a tuition reduction cannot exclude it from gross income unless he or she is engaged in teaching or research activities for the educational organization.[221] Section 117(c) seems to limit these exclusions if the student is required to perform teaching, research, or other services in order to receive the qualified scholarship or tuition reduction.[222] Therefore, a student who is a teaching assistant while in graduate school may exclude a tuition reduction as long as the assistantship and the tuition reduction are not directly linked. All graduate students should receive equal tax treatment and so those students with scholarships should be required to include the scholarships in gross income, just as tuition reductions are includable in gross income for some graduate students. Graduate students who receive tuition reductions from their employer, and are not teaching or research assistants, are at a tax disadvantage because they cannot exclude that income as a scholarship student or teaching assistant could.[223] Because the effects of tuition reductions and scholarships are the same, they should receive equal tax treatment as well.

Another inconsistency in the tax code is that tuition cannot be deducted for students who are learning a new trade or business under section 162.[224] Education expenses may only be deducted as ordinary and necessary business expenses if the education maintains or improves skills required in the individual's trade or business or meets express requirements of an employer.[225] Many students attend graduate school for the purpose of learning a new trade or business. However, if the student is pursuing education for the purpose of learning a new trade or business, it is considered a personal expenditure and,

218. I.R.C. § 117(d)(2) (2003).
219. *Id.*
220. *Id.* § 117(d)(5).
221. *Id.* § 117(d)(2), (5).
222. *Id*. § 117(c).
223. I.R.C. § 117(d)(5) (2003).
224. Treas. Reg. § 1.162-5(a) (as amended in 2003).
225. *Id.*

therefore, is not deductible.[226] The inconsistency is that scholarship students who return to school for the purpose of learning a new trade or business have a tax advantage over those without scholarships. Those scholarship students have a tax break because they may exclude their scholarships from income while those without scholarships cannot even deduct their tuition. Students pursuing an advanced degree for the purpose of learning a new trade or business should be treated consistently under the tax code. Therefore, to equalize the tax inconsistency, either section 162 should be modified to allow students to deduct costs of their education incurred in pursuing a new trade or business, or section 117 should be modified to tax those students on scholarships used to attain a degree in a new trade or business.

Sections 127 and 117 treat income differently for graduate students as well. While section 117 allows graduate students to exclude their scholarships from gross income,[227] section 127 does not allow graduate students to exclude employer assistance from gross income.[228] One of the reasons that employer assistance is not excludable from gross income under section 117 is because in most cases "employer 'scholarships' will be compensatory, and hence not excluded under IRC 117(a)."[229] This is because section 117(c) provides that any amount received by the student, which represents payment for services as a condition of the scholarship, cannot be excluded from gross income.[230] An argument can be made that an employer only furnishes the educational assistance because the student works for them and the assistance represents payment for their work. However, there is no difference between employer assistance and a scholarship; employer assistance is a form of a scholarship. Whether a student receives a scholarship from an outside source or assistance from an employer, both amounts should be treated the same. If the student who received assistance from an employer must pay taxes on that money, then a student who receives assistance from outside sources in the form of a scholarship should also be required to pay taxes on those funds.

### *D. Arguments Against Taxing Scholarships*

One argument against taxing scholarships suggests that taxes will eventually be paid when the student realizes income in the future.[231] Because students will eventually pay taxes when they graduate, there is no need to tax the student while he receives the education.[232] However, the tax inequity

226. Treas. Reg. § 1.162-5(b) (as amended in 2003).
227. I.R.C. § 117 (2003).
228. *Id.* § 127.
229. INTERNAL REVENUE SERVICE, *supra* note 35.
230. I.R.C. § 117(c) (2003).
231. Crane, *supra* note 209, at 82.
232. *Id*.

problem of students without scholarships paying more taxes in total still exists. Students without scholarships have to pay taxes on income used to fund their education as well as on the income received after graduation. This argument still lets scholarship students off the hook.

Another argument against taxing scholarships is that some scholarships are awarded for academic success and, therefore, are a reward to these students who deserve to pay less for their education. The very nature of the ability-based scholarships is that they are exclusive; not everyone can receive them. But there might be equally worthy students who, for whatever reason, did not receive a scholarship. Because scholarship students already receive the benefit of having to pay less for their education, they should not receive the further benefit of avoiding taxes. Even if scholarship students were taxed, they would still be paying less for their education than others, so that goal would be met. Some commentators argue that ability-based scholarships involve a social investment, and society receives the greatest payoff while the individual benefit is incidental.[233] Because the individual benefit is incidental they argue that the scholarship should not be taxed.[234] But society receives a benefit when as many people as possible obtain higher education, and those without scholarships should not be at a tax disadvantage because they add value to society as well.

Another argument opposes taxing scholarships because many scholarships are need-based. However these students would not be greatly affected by a tax on their scholarships because the tax could be taken upfront before the distribution to the school is made. They would not have to find more funds to pay the tax out of their own pockets. In addition, it is likely that scholarship foundations may donate even more money to the recipient so that he would still receive the same proportion of assistance. One of the goals of the 1997 Taxpayer Relief Act was to make higher education more accessible and more affordable.[235]

Lastly, some argue that because scholarships are not often granted in cash, but as a credit, and because the student has no control over those funds, they should not be taxed.[236] However, the student in fact is receiving the benefit of payment for their education; whether or not the student can control how the money is distributed should not be determinative. Also, in some cases, scholarships are given for living expenses, and students are allowed to control how that money is spent. The student can choose where to live and how much to spend. If the test for taxing scholarships were whether or not the student has control over the funds, the results would be mixed. Taxation of all

233. *Id*. at 83.
234. *Id*.
235. Albus, *supra* note 5, at 601.
236. Crane, *supra* note 209, at 82.

scholarships would lead to a consistent result and equal treatment to all students of higher education.

## V. CONCLUSION

Because of the history and purpose of sections 117 and 127, the unequal tax treatment of graduate students, and the ineffectiveness of tax breaks to equalize the tax treatment, scholarships awarded to graduate students should be taxed. In the current state of the tax code, graduate students without scholarships are at an economic and tax disadvantage. Because higher education is necessary for societal and individual interests, and because the cost of education makes it very difficult for students to attend graduate schools, students should at least be guaranteed equal tax treatment.

Alternatively, if scholarships are not taxed, the current tax breaks should be expanded to equalize the tax inequality and provide better benefits to those graduate students without scholarships. One method of accomplishing this would be for Congress to increase the Lifetime Learning Credit to allow a percentage refund of a greater amount (for example, $30,000 per year). Most graduate programs cost more than the current allowable amount.[237] Also, the Lifetime Learning Credit "qualified education expenses" should be expanded to include other necessities besides tuition, such as books, parking, or required student fees. These expenses are just as much a necessity of attending school as tuition, and students should be allowed to include these expenses in calculating the credit. Another way of leveling the playing field between students would be to disallow students on scholarships to take advantage of this tax credit. Currently, students with scholarships may still take advantage of the credit for the portion of their "qualified education expense" that is not covered by scholarship funds. If scholarship students could not take advantage of the Lifetime Learning Credit, this would be one way of leveling the tax disadvantage. Another proposed solution could be to give federal grants to financially needy graduate students. These grants are only available to undergraduate students with financial need, but a grant to graduate students would have the same financial effect as a scholarship. One last solution to alleviate the tax disadvantage might be to let students who did not have scholarships pay tuition or student loan debt with pre-tax dollars. Increasing the tax breaks for those students without scholarships might help to alleviate

237. For the 2001-2002 school year the average graduate school tuition at public and private schools was $8,891; $18,577 for law school; $19,973 for medical school; $22,643 for dental school. NCES, *Table 315*, *supra* note 194.

some of the tax inequality but might not completely level the playing field. Ultimately, expanding the tax credits would require more time and effort, and the same result could be achieved by simply excluding graduate scholarships from section 117.

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