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viewpoints

No HOPE (Credits) For Louisiana Coffers

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Market forces often redistribute the benefit of tax incentives to unintended beneficiaries. There is wide agreement, for example, that the substantial tax expenditures for employer-provided medical care have been a major factor over the years in spiraling health care costs and the arguably excessive payments to health care providers, both individual and corporate.¹ While most of these unintended beneficiaries of tax expenditure largesse are individual or corporate taxpayers, state and local governments have also been unintended beneficiaries of tax expenditures, sometimes as employers, but also as owners of educational institutions and in myriad other ways. Thus, it should not be surprising to discover that a significant portion of the benefit of the recently adopted higher education tax incentives has been captured by colleges and universities through increases in tuition and reductions in financial aid.

Legislative action has made the state of Louisiana a principal — but distinctly unintended — beneficiary of the federal tuition tax credits.

The tax system more or less accepts as a cost of the tax expenditures involved the unintended benefits that flow from such tax expenditures through macro-

economic market processes to various unintended beneficiaries. The docile acceptance of this "leakage" may be bad policy and certainly warrants closer legislative review, but it clearly represents the current and long-standing state of the income tax system.

By contrast, it is unacceptable for a taxpayer to undertake a specific transaction for the sole purpose of obtaining an unintended tax benefit — a tax benefit that Congress plainly did not intend the taxpayer to have. The recent spate of corporate tax shelters is the most obvious example of that activity. But Louisiana, through recent amendments to its Tuition Opportunity Program for Students (TOPS), seems to have decided that legislative action may also be a useful technique for making the coffers of the state of Louisiana a principal — but distinctly unintended — beneficiary of the federal tuition tax credits. We think that action is highly inappropriate in all respects. We also think Louisiana's action should be thwarted before other states decide to emulate the example.

In adopting the tuition tax credits, Congress walked a narrow path between providing needed relief from the spiraling costs of higher education and containing the budget-busting potential of this new tax expenditure. As a result, the assistance contained in the tax credits is sharply limited and reasonably well-targeted to the neediest. Creditable expenses are limited to tuition and fees. The credit is limited in amount and is entirely phased out for upper-middle-class taxpayers. And, with the most justification, the credit is limited to expenses actually incurred by the student or his or her family. To the extent that otherwise creditable costs are in fact refunded by the institution or defrayed by a scholarship or other tax-exempt educational assistance allowance, they are, of course, not creditable.²

The regulations proposed under the tuition tax credit in January 1999³ anticipate that a refund of tuition for one year, the "tuition year," may occur in a subsequent year. When that occurs, both common sense and elementary principles of income tax law would require that any credits claimed for amounts ultimately not paid would have to be repaid to the Treasury as an additional tax. To avoid unnecessary reporting, the regulations provide that if the refund is received after the end of the tuition year but before the filing of a tax return for that year claiming the credits,

¹See, e.g., Paul J. Donahue, "Federal Tax Treatment of Health Care Expenditures: Is It Part of the Health Care Problem?" 46 Wash. U. J. Urb. & Contemp. L. 141 (1995); Henry J. Aaron, "Tax Issues in Health Care Reform," 47 Nat'l Tax J. 407 (1994).

²Section 25A(g)(2).

³Regulations were proposed under section 25A on January 6, 1999.

the refund should nevertheless reduce the amount of the tuition deemed paid in the tuition year and thus reduce the amount of the credits claimed.⁴ However, when the refund is received after the return for the tuition year was filed, the amount of the credit claimed for the tuition that is refunded must be returned as additional tax in the year the refund is received.⁵ No other rule seems possible.

Long before the adoption of the tuition tax credits, Louisiana, like many other states, extended to its residents some relief from the costs of higher education. Under the TOPS program as originally set up,⁶ a state scholarship was paid on behalf of qualified students in an amount roughly equal to the tuition charged by public colleges in Louisiana. That amount was the state's contribution to ameliorating, if not solving, the problem its residents face in meeting the costs of higher education. Until last year, TOPS payments were generally made by the state directly to the educational institution.⁷ These payments — quite plainly, amounts that the students did not have to pay as tuition — clearly did not entitle the students to claim tuition tax credits. The Louisiana Legislature, however, was not content with this fairly predictable consequence and took actions that we believe inappropriate.

The Legislature set up a program that encourages Louisiana residents to conceal their federal income tax liabilities.

Effective July 2, 1999, the Legislature amended the TOPS program to allow a student to elect "to delay the acceptance of his financial assistance award until after the student . . . files his federal income tax return."⁸ If the student or the student's parents elect this delay and do not claim a federal tuition tax credit, then an amount equal to the award that would have been paid to the institution is paid directly to the student.⁹ However, if the student does claim a tuition tax credit, then the payment to the student is reduced by the amount of the credit claimed but increased "as an incentive for claiming the credit and thus reducing the cost to the state of this program, by an amount equal to twenty-five percent of the amount of the credit claimed."¹⁰ If the claim for the federal credit is denied, no additional payment is to be made by the state.¹¹

⁴Prop. reg. section 1.25A-5(f)(2).

⁵Prop. reg. section 1.25A-5(f)(3).

⁶La.R.S. 17:3048.1, as in effect prior to 1999 amendments.

⁷La.R.S. 17:3048.1(E)(1).

⁸La.R.S. 17:3048.1(K)(3)(a)(i). The 1999 amendments to the Louisiana program are discussed in Susan Kalinka, "TOPS Scholarship Recipients Who Failed to Claim the Education Tax Credits for 1998 Should Consider Filing Amended Returns," 60 *La. L. Rev.* 281 (1999).

⁹La.R.S. 17:3048.1(K)(3)(a)(iii).

¹⁰La.R.S. 17:3048.1(K)(3)(a)(ii).

¹¹La.R.S. 17:3048.1(K)(3)(e).

Point One. That leads us to point No. 1. Without any question at all, the tuition tax credit is a fairly modest federal program designed to help students and their families. The program was not to any extent intended to operate as an intergovernmental grant program that would allow state governments to retreat from their fairly modest assistance to students. Yet the Louisiana Legislature here is attempting to capture a major portion of this tax expenditure for itself while simultaneously reducing its support of education. It was improper for the Legislature to attempt this diversion of federal aid to education, and the attempt should not be allowed to succeed. Now back to our story.

On the face of the matter, this election under Louisiana law is very mysterious. The student can, if he or she wishes, ignore this odd election, accept the scholarship, and be done with the matter. The election makes sense only if it leaves the student better off than the student would be by simply accepting the scholarship and not incurring the tuition expense at all. Indeed, one suspects that the Legislature intended that the student be better off by the amount of the 25 percent "incentive."

To see how this works out, let's use the example of a student who has a tuition expense of \$2,600, said to be the tuition at Louisiana State University in 1999,¹² and is eligible for the federal HOPE credit. If the election is taken, the results would be:

Disbursement for tuition	(\$2,600)
HOPE credit	\$1,500
Net cost of LSU	(\$1,100)
TOPS award	\$1,475 (\$2,600-\$1,500+\$375)
Benefit (compared with not electing)	\$375

But now, of course, the student has received a scholarship that reduces the amount of tuition for which a credit may be claimed. On the net tuition cost of \$1,125 (\$2,600-\$1,475) the credit would be \$1,062.50; thus the excess credit of \$437.50 must be repaid to the IRS. Reducing the expected benefit by this tax payment demonstrates that as a result of the election the student is worse off by \$62.50 (\$437.50-\$375). At this point, of course, the student might go back to the state, point out that the federal credit had been reduced, and request an increase in the state award. While we disclaim expertise in the subtleties of Louisiana law, the provision barring additional payments when "a federal income tax credit claim for tuition is disallowed" might well bar that circularity.

It seems unlikely that Louisiana amended the TOPS program to victimize its residents. Instead, as noted above, it seems likely that the Louisiana Legislature intended for the student to be better off as a result of claiming the tuition tax credit by the amount of the 25 percent "incentive." Achieving that result, however,

¹²Kalinka, *supra* note 8, at 290.

requires that the student not report the belated receipt of the TOPS award, thus failing to return the excess amount of credit claimed.

Point Two. We are a little tentative about our conclusion here because we really do not know what was going on in the minds of the Louisiana legislators in adopting this provision. However, a plain-meaning reading of the statute and of the existing interpretative literature¹³ suggests that in seeking to capture the benefits of the federal program for the state of Louisiana, the Legislature set up a program that encourages Louisiana residents to evade their federal income tax liabilities. While that conclusion is intuitively astonishing, the amended program's delayed-payment option makes sense only if the residents fail to repay excess credits to the IRS. Whether this was intentional or accidental or simply the result of ignorance, for state law to encourage the avoidance of federal taxes is highly objectionable.

Perhaps there is a somewhat different explanation for how the Louisiana statute is supposed to work. In 1999, the Louisiana Legislature also amended the TOPS program to provide that instead of the state paying the student's tuition, the student is to be awarded "an amount" determined "to equal" tuition.¹⁴ The notion here appears to be that because the state is not requiring that the award be used to pay tuition, the student can elect to treat the award as something other than a scholarship exempt from tax under section 117. The award, this reasoning goes, then constitutes taxable income and its receipt by the student does not require a repayment of the tuition tax credit. Under some configurations of income and tuition costs, the burden of this tax, if any, will be less than the burden of refunding any excess tax credits. Indeed, when tuition costs are low relative to the amount of the tax credit, the delayed acceptance of a taxable award might leave the student better off than if the delayed award election had not been made, but the amount of the TOPS award was simply excluded as a scholarship at the outset. For example, in the example given above, if the TOPS award is included in income and the student is in the 15 percent bracket, the student would owe \$221.25 in federal income tax and would come out ahead by \$153.75. (This benefit to the student, however, is a small fraction of the nearly \$1,500 that Louisiana saves.)

There are a number of distinct approaches to treating the state award as a taxable receipt, and one or another, surprisingly, may succeed.¹⁵ However, the

Louisiana Legislature was relying on just one: An award in the amount of public college tuition, which is reduced for students whose tuition payments are reduced or excused under other state programs and is reduced by the value of the federal tax credit for tuition and which is repeatedly defined and discussed in the legislation in terms of "tuition," can be characterized by the student as something other than a refund of tuition costs or a scholarship, so that the student is not obligated to repay any part of the claimed HOPE tax credit.

Point Three. We recognize the complexity of federal tax law, the uncertainty of outcomes, and the fact that arguments as flaky as this sometimes prevail. So we do not wish to characterize this one as right or wrong, or negligent or fraudulent. However, this is exactly the kind of aggressive, insubstantial, almost nihilistic reasoning that characterizes the truly reprehensible corporate tax shelters that seem to have captured the imagination of corporate America. The fact that the Louisiana Legislature is in a position to write legislation to bolster its case does not make its argument any more persuasive. Indeed, we find it particularly objectionable for a state government to engage in such behavior.

In any event, we are dubious that the election to delay the receipt of a state award was designed under the assumption that the reduced award would be included in income. If the award from the state is assumed to be taxable (or the student is assumed to be able to elect to treat it as taxable) and thus not to detract from the student's ability to claim a tuition tax credit, it would be foolish for the student to elect to delay the receipt of the award and thereby be forced to accept a reduced award. The student would always be better off claiming the full (presumably taxable) state award and claiming the undiminished tuition tax credits. If students all acted in this rational way, Louisiana would end up gaining nothing from its elaborate redesign of the TOPS program to allow a delayed payment. We doubt very much that this is what Louisiana intended. Rather, the attempt to create an award that is taxable or excludable at the student's option seems to be an alternative to seeking a delayed award. For that reason we think we may be right in Point Two, that the TOPS program is designed to encourage some Louisiana taxpayers to ignore the federal tax liability for repayment of excess credits arising out of delayed receipt of the TOPS awards.

The difficulty with the amendments to the TOPS program is not so much that they exploit weaknesses in the drafting of the law and regulations governing the tuition tax credits, because we doubt that those efforts were successful. The difficulty is that a state government in its official capacity has followed no principle but blind greed in attempting to make itself an unintended beneficiary of the federal tuition tax credits program. Louisiana has set a bad example.

¹³Kalinka, *supra* note 8, at 285.

¹⁴1999 La Acts. No. 1302, amending La.R.S. 17:3048.1.

¹⁵Because section 117(b)(1) requires as a condition for excluding the amount from income that a taxpayer demonstrate that the award was used for tuition, it has been suggested that the exclusion is elective: If the taxpayer declines to make the demonstration, the award becomes taxable. (It should be noted that prop. reg. section 1.25A-5(c)(3)(ii) seems to reject this interpretation for purposes of section 25A.) Second, prop. reg. section 1.25A-5(c)(3)(i) suggests an otherwise excludable scholarship may be reported in income. Neither of these approaches to converting a scholarship into taxable income relies on the manner in which the award is used.