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WHO SHOULD BE ENTITLED TO CLAIM THE NEW EDUCATION CREDITS?

by Glenn E. Coven

In 1997 Congress at long last undertook to provide some relief from the spiraling costs of higher education. Naturally, the relief was extended through the income tax system and assumed a variety of forms. The central feature of the new legislation was the adoption in section 25A of two types of education tax credits. As has become characteristic of tax legislation, section 25A and the other education assistance provisions were very poorly designed and executed. One particularly ill-considered aspect of this legislation was the seemingly simple question of who is to be entitled to claim the new credits. In most families, after all, both the parents and the child make some contribution to the cost of higher education. This problem, of course, is not new. Dependent children who earn income have always incurred deductible expenses, some of which were paid by the child and some of which were paid by the parents. The treatment of these payments has always been governed by the generally applicable rules of taxation.

In drafting the educational credits, however, Congress ignored that traditional approach and adopted instead a series of novel solutions to the problem of allocating tax allowances between parents and their dependent children. Those solutions were terribly misguided. In an valiant effort to make sense out of this legislation, the Treasury has issued proposed regulations containing solutions that are equally novel and equally misguided. The difficulties with this statutory/regulatory approach to the allocation of credits are catalogued here in the hope that the section 25A approach does not spread to other legislation.

I. The Education Credits at a Glance

For no very important reason, section 25A creates two distinct credits. The rather misleadingly named HOPE scholarship credit reimburses 100 percent of the first $1,000 of education expenses and 50 percent of the next $1,000 for a maximum credit of $1,500. The credit may be claimed without limit for each eligible student.

1In addition, section 530 added an IRA-like savings account for education expenses and section 220 allows a limited deduction for interest on loans for education. Section references are to the Internal Revenue Code of 1986, as amended, and the regulations thereunder.
but is only available, in general, for each of the first two years of college-level education. The Lifetime learning credit is equal to 20 percent of education expenses to a maximum of $5,000 ($10,000 after 2002) and can be claimed in an unlimited number of years (but not with respect to the expenses of a student for which a HOPE credit is claimed). The Lifetime credit is a per-taxpayer credit; the $5,000 or $10,000 ceiling applies without regard to the number of students that the taxpayer is supporting. For both credits, the expenses for which credit may be claimed are limited to tuition and most fees paid by the taxpayer for the education of the taxpayer, his or her spouse, and any dependent and excludes expenses paid by a tax free receipt (such as a scholarship) other than a gift. The ability to claim either credit is phased out for taxpayers having adjusted gross income (AGI) in excess of $50,000 on a joint return and disappears at $100,000. There are, of course, a number of other rules governing the credit, some of which are the subject of the following remarks.

II. Who Gets the Credit and for What

In allocating the education credits between parents and child, section 25A embodies an all-or-nothing approach: in any given year, only one taxpayer can claim an education credit for any given student. The identity of that taxpayer depends on whether a dependency exemption for the student is allowed to another taxpayer. If the exemption for the student is allowed to another, the student is barred from claiming any education credit — even if the student actually pays his or her own expenses out of his or her own earned income. Rather, the credit must be claimed by the person to whom the dependency exemption is allowed. On the other hand, if the exemption is not allowed to another, no one but the student may claim the credit. Just when a dependency exemption "is allowed" to another taxpayer is discussed below.

When the credits are to be claimed by someone other than the student, the credit for expenses actually paid by the student is not necessarily lost. Under section 25A(g)(3)(B), in this situation, expenses paid by the child are treated as if they had been paid by the parent (or other person entitled to the dependency exemption), thus entitling the parent to claim a credit for those expenses. The code thus assigns to the parent the income tax benefit for expenses paid by a child out of the child’s own funds.

When the student is not a dependent and thus must claim his or her own credits, the code lacks a comparable rule attributing the expenses paid by the parent to the student. While this different statutory treatment might suggest a different result, the proposed regulations do not take that approach. Rather, under prop. reg. section 1.25A-5(a), education expenses of a student that are paid by a third party, normally the parent, are treated as if they passed through the hands of the student. Thus, the third party is treated as making a gift to the student and the student is treated as paying his or her own expenses. That treatment entitles the student to claim the education credit for his or her education expenses that are in fact paid by another (unless, of course, the student is a dependent of another in which event the expenses are re-treated as paid by that other person3). Although the regulations are not sufficiently clear on the point, presumably the rule of 5(a) would be applicable regardless of the fact that it is the parent that is legally obligated to the educational institution to pay the expenses.

A. The Novelty of the Allocation Rule

In barring the claiming of credits by one for whom the personal exemption is allowed on the return of another, Congress may have thought that it was following an established precedent. It wasn't. No other section of the code disallows a tax benefit for an out of pocket expenditure to a taxpayer simply because that taxpayer could be claimed as a dependent on another’s tax return. Section 151(d)(2) bars an individual from deducting his or her own personal exemption if another taxpayer may also deduct a personal exemption attributable to that individual. The personal exemption, however, does not reflect a specific disbursement. In fact, the exemption is really an aspect of the rate structure and functionally imposes a zero rate of tax on the first slice of income. Section 151(d)(2) quite appropriately bars a second exemption to a child when an exemption has already been claimed by the parent.

Section 63(c)(5) limits the use of the standard deduction to offset tax on the investment income of an individual who can be claimed as a dependent on the return of another. Again, this provision does not provide a tax benefit for a specific expenditure. Today's standard deduction is designed to provide a measure of tax relief to low-income taxpayers who lack specific personal deductions. Section 63(c)(5) reflects the entirely reasonable decision to discourage certain income splitting techniques by denying that relief to the unearned income of minors.

A similar disallowance is contained in section 220. That section, added in 1996, allows on an experimental basis a deduction for amounts contributed to medical savings accounts. The funds accumulated in such an account may be used to pay the medical expenses of the taxpayer and his or her dependents. Under section 220(b)(6), dependent children are barred from creating

3Seriously. The proposed regulations give this example. Child is a claimed dependent of divorced Mom. Ex-Hubby pays Child's tuition. Who gets the credit? Mom! See prop. reg. section 1.25A-5(b)(2). The rule is favorable to taxpayers because it preserves the credit but otherwise makes no logical sense at all.
their own accounts. That decision, while perhaps not entirely beyond criticism, still does not bar a child from deducting an out-of-pocket expenditure. Rather, section 220 bars dependent children from making an expenditure by denying them the opportunity to establish a medical savings account. Significantly, if such a child does have a medical expense that the child in fact pays out of his or her own funds, the child at that time is entitled to a deduction under section 213.

This new rule governing the allocation of the education credits is objectionable for a series of reasons.

The extension of this concept in section 25A, therefore, is novel. Unlike its predecessors, the education credit is the first instance in which expenses of a dependent child, paid by the child, have been reallocated to another. In spite of the significance of this change in the manner of taxing family income, there is no indication that the drafters of section 25A considered the desirability of this approach or the extent to which it should be extended to other provisions. Indeed, there is no indication that the drafters even were aware that they were adopting a novel tax concept.

B. Objections to the Allocation Rule

This new rule governing the allocation of the education credits is objectionable for a series of reasons.

1. A rule that denies a taxpayer the tax benefit from his or her own expenses and gives that benefit to another is, and will be perceived by taxpayers as, unfair. Of course, an amateur economist could explain that the credit is just as valuable, maybe more valuable, in the hands of the parent as in the hands of the child. However, the arguments would not have impressed my children and, I suspect, will not impress many others. Rather, this provision will leave many new taxpayers believing themselves to have been cheated out of a tax credit, thus planting a seed of hostility toward the tax system in the application of a provision that should have left the student with a friendly feeling.

2. The assignment of income doctrine, which requires each taxpayer to report his or her own items of income and expense, is a central protection of the integrity of the code. The rules that flow from that doctrine have the effect of stemming taxpayer manipulations calculated to avoid the progressive rate structure or otherwise improperly reduce tax liability by engaging in transactions that lack economic substance. Section 25A(g)(3) requires a clear and egregious violation of that rule. One taxpayer is given a tax benefit for a loss economically incurred by another. For Congress to require, or even authorize, violations of such fundamental rules is highly undesirable. It is difficult enough to maintain taxpayer respect for broad anti-tax avoidance doctrines without Congress deliberately undermining them.

3. This violation of the assignment of income rules is particularly unfortunate because it creates internal inconsistency within the code. In other, quite similar areas, the normal assignment of income rules apply. That means that in closely related areas under the tax law, two sharply inconsistent results are required. Thus, when a dependent child pays his medical expenses, he is entitled to a deduction but when he pays his education expenses, his parent is entitled to the credit. Such inconsistent rules are an obvious and wholly unnecessary source of complexity and taxpayer confusion.

4. In treating expenses paid by the parent as if they were paid by the child, the regulations have suspended the application of a second important anti-tax avoidance rule, the step transaction doctrine. In the absence of this regulation, a parent wishing to cause a child to be treated as having paid certain education expenses would face a significant hurdle. If the parent transferred funds to the child that the child promptly retransferred to the educational institution, a routine application of the step transaction doctrine might well bar the desired result. Since the child would be acting as a mere conduit and the funds did not come to rest in the hands of the child, the child's involvement in the transaction would be ignored and the payment treated as passing directly from the parent to the institution. Since the child would not be regarded as paying the expense, the child would not be entitled to any credit.

The regulations evidently suspend the application of the step transaction doctrine in this context. Even though the child may play the role of the most embarrassingly obvious conduit, the tax law will treat the child as the bona fide payor of the expense and entitled to the resulting tax benefit. Of course, the application of the step transaction doctrine in this intra-family context would be difficult, as its application usually is. And, the application would also produce a harsh result. If the credit must be claimed by the student but the expenses are paid by the parent, the credit for those expenses would be lost absent the regulatory rule. Nevertheless, undermining the validity of the step transaction doctrine is as short-sighted as is the undermining of the assignment of income doctrine. If these rules are to be waived by the government for little or no reason, taxpayers will find in that justification for ignoring the application of those rules in other contexts.

5. The code expressly attributes payments by the child to the parent; it quite clearly does not attribute payments by the parent to the child. Obviously, the distinct possibility exists that these different rules were the result of an oversight by the drafter of section 25A. Nevertheless, the code plainly adopts a different rule which the regulations plainly ignore. The regulation would thus seem to strain the boundaries of the Treasury's interpretative authority. Significantly, the rule indicated by congressional silence is that taxpayers are required to report their own expenditures and it is that fundamental rule that the Treasury regulations ignore. Perhaps the boundaries have been breached.

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4 After all, one must have an income tax liability before credits are of any value.
III. When Is an Exemption ‘Allowed’ to Another?

Wrongly or not, section 25A(g)(3) denies an education credit to a student if the deduction for the personal exemption attributable to the student is “allowed” to another. Just what the drafters of section 25A mean by “is allowed” is an interesting question. Under the antecedent sections 151(d) and 65(c), the respective allowances are barred to an individual if the personal exemption for that individual is “allowable” to another. Under those sections, it is well established that “allowable” means “entitled to claim the benefit whether or not it is in fact claimed and whether or not it does the taxpayer any good.” The principal practical effect of the use of “allowable” in section 151 arises in connection with the phaseout of the personal exemption. Under section 151(d)(3), the ability to deduct this allowance is reduced for taxpayers whose adjusted gross income on a joint return exceeds about $190,000 and entirely disappears when income exceeds about $312,000. As the value of the child’s personal exemption disappears, the high-income parents cannot pass the deduction to the child by foregoing the deduction on their own return. Because the personal exemption was “allowable” to the parent, although not in fact claimed, the child remains barred from claiming his or her own personal exemption. Thus the use of “allowable” in section 151 prevents the avoidance of the phase-out rules.

Just what the drafters of section 25A meant by ‘is allowed’ is an interesting question.

In paragraph (g)(3) of section 25A, however, Congress used different language. The credits are not barred to a child if a deduction for the child’s personal exemption is “allowable” to another; rather, they are barred if the deduction “is allowed” to another. Did that different choice of language signal a different meaning? In the portions of the code that address depreciation and the resulting adjustments to basis, such as section 1016, the words “allowed” and “allowable” are given distinct meanings. Allowable means the proper amount of depreciation prescribed by law while allowed means the amount of depreciation actually taken on the income tax return, which may be more or less than the amount properly allowable. If this meaning of allowed applied to the use of that word in section 25A, it would suggest that the education credits are barred to a child only if the parent actually claimed the personal exemption for the child — regardless of whether the deduction was allowable.

On the other hand, elsewhere in the code allowed does not seem to have been given such a specialized meaning but rather is used in its conventional sense of meaning permitted. Illustrations occur in virtually every section of the code. Indeed, when allowed is used in this sense, it is sometimes used interchangeably with allowable. If section 25A is using allowed in this sense to mean permitted, then education credits are barred to a child if the parents are permitted to claim the child’s personal exemption regardless of whether they do.

The legislative history is of no help. In describing section 25A(g)(3), the reports refer to whether the taxpayer “claims” the student as a dependent, which might be read as supporting the section 1016 meaning of allowed. However, section 24, which extends the child tax credit, was enacted along with section 25A and like that section conditions its relief on whether the taxpayer is “allowed” a deduction for the child’s personal exemption. In describing that provision, the reports refer to whether the taxpayer “can claim” the deduction.

The proposed regulations to section 25A(g)(3) adopt the section 1016 meaning of allowed. Under section 1.25A-1(g), if a taxpayer is eligible to claim a student as a dependent but does not, then the personal exemption is not treated as “allowed” to the taxpayer. Accordingly, paragraph (g)(3) does not apply and the student can claim the education credit for the costs of his or her own education. In the process of creating this rule, the regulations invent the new concept of a “claimed dependent.” A claimed dependent, of course, is a dependent for whom the taxpayer actually claims the dependent. The regulations define a claimed dependent as one for whom the personal exemption is “entitled” to claims, although that is far from clear. Reading the proposed regulations in this manner, if the deduction for the personal exemption on the taxpayer’s return is “unclaimed.” Presumably, if the taxpayer could have, but did not, claim the deduction, the dependent is “unclaimed.” Apparently, taxpayers are permitted to switch the status of their dependents from claimed to unclaimed annually without limitation but the regulations are silent on that point.

The proposed regulations do not address, at least not expressly, the painfully obvious issue of the interaction of the concept of a claimed dependent and the phaseout of the deduction for the personal exemption. Section 1.25A-1(g) only rather vaguely states that if a taxpayer “is eligible to, but does not, claim” the child, then the child is unclaimed. One can only guess that if a deduction has been fully phased out for the taxpayer, then the taxpayer is not “eligible” to claim the dependent, although that is far from clear. Reading the proposed regulation in this manner, if the deduction for a child’s personal exemption has been reduced to, say, $54 by the phase-out of the allowance, the child

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7 Compare, e.g., section 32(a)(2) (“the amount of the credit allowable . . . under paragraph (1)’’ with section 221(b)(1) ("the deduction allowed by subsection (a)").
9 Section 24(c)(1)(A).
11 Actually, the regulations with infuriating ambiguity define a claimed dependent as one for whom the personal exemption is “allowed” to the taxpayer but we know what they mean. Prop. reg. section 1.25A-2(a).
remains a claimed dependent. However, if the deduction is reduced to zero, the child automatically becomes an unclaimed dependent.

If these regulations correctly interpret section 25A(g)(3), then the allocation of the education credit between parent and child is elective and that election is fully within the control of the parties. Maybe so, but there is no indication in the committee reports that Congress understood that paragraph (g)(3) created an election. Certainly it would have been unconscionably devious for Congress to create a surprising and significant rule but communicate its existence only through a subtle and ambiguous word ending. It seems more likely that the drafters of section 25A never thought matters through this far and that the elective feature is one dreamed up by the Treasury as a means of blunting the harshness of the congressional denial of the credit to a dependent child who pays his or her own way.

IV. Deficiencies in the Elective Allocation

Whether this election is one intended by Congress or manufactured by the Treasury, however, it is both novel and very poorly constructed. It is novel because Congress has not previously treated the status of a dependent for whom the personal exemption can be claimed by another as an election within the control of that other taxpayer. It is poorly constructed for all of the following reasons.

A. The Inherent Complexity of Elections

Elections, while normally appearing favorable to taxpayers, generally reflect bad policy and are not in the best interests of taxpayers. The very existence of an election creates complexity and mandates tax planning with its attendant expense. In addition, elections undermine the notion that tax issues have a correct interpretation of section 25A distinctly unfair. It is poorly constructed for all of the following reasons.

B. Intentional Forfeiture of the Personal Exemption?

The notion that allowed means actually claimed permits the parent to shift the education credits to the student/child by failing to claim the personal exemption for the child on their (the parent's) return. But, the personal exemption itself, of course, is denied to the child if the deduction for their personal exemption is allowable to another. Accordingly, if the parent does forgo the deduction for the personal exemption, the child nevertheless cannot claim that allowance — it is permanently lost to all. The proposition then that allowed means claimed is that, in the context of legislation designed to assist families and particularly to assist in paying the costs of education, Congress allowed the education credits to be claimed by the student but only at the price of forfeiting the student's personal exemption. Even for this Congress, that would be bizarre.

It would also be manifestly unfair. If an elective shifting of the education credit is to be allowed, it is not necessarily inappropriate to attach a reasonable cost or penalty to the making of that election. However, the forfeiture of the personal exemption is not such a penalty. It is grossly unreasonable and will be so viewed by taxpayers. Not only is the amount of the penalty imposed excessive, a point illustrated below, but the loss of the personal exemption for the very student whose education expenses the new provisions are designed to defray is, and will appear to taxpayers, as senseless and counterproductive, another instance of being shortchanged by Congress.

It is the forfeiture of the personal exemption to all that makes the regulatory interpretation of section 25A(g)(3) distinctly unfair.

It must be underscored that the overall result of this elective shifting of the credit is not at all similar to the mandatory shifting of the credit to the student/child that will occur when the child is no longer a dependent. At that point, the parent loses the deduction for the child's personal exemption and is no longer able to claim education credits attributable to the child. Rather, the student must claim his or her own education credits. However, here the deduction for the personal exemption is not forfeited; the child can now deduct his or her own exemption. It is the forfeiture of the personal exemption to all that makes the regulatory interpretation of section 25A(g)(3) distinctly unfair.

It would also be expensive. At the 28 percent bracket, which is the bracket in which many parents of college-age students find themselves, a deduction for the current exemption of $2,700 results in a tax savings of $756. For such a taxpayer, forfeiting the personal exemption means increasing one's tax liability by that amount. On the other hand, the maximum HOPE credit that can be claimed for a single child is only $1,500 (and the maximum Lifetime credit is currently only $1,000). If a parent in that tax bracket shifted the entitlement to a HOPE credit to a child, the net benefit obtained by the family from the credit would be $1,500 less $756, or $744. Accordingly, the proposition asserted by the regulations is that Congress did allow shifting the education credit to the children but, if that occurred, the value of the credit was to be halved. That result is simply ridiculous and it is just very hard to believe that it was intended by Congress. Of course, it might have been that the drafters of section 25A did intend that parents could shift the credit to their children but they forgot that parents cannot shift the personal exemption itself! Hard to say.

C. A Deliberate Undermining of the Limitations?

There are two obvious reasons why a parent might wish to shift the credit to the child. One is the non-tax factor of family harmony. Older children tend to become incensed when they discover that they must pay a tax on relatively meager earned income (not to mention trivial amounts of savings account interest) be-
cause their parents get the deduction for their personal exemption. When those children discover that they cannot get an education credit with respect to amounts of their own income that they have used to pay their education expenses, their irritation will, on occasion, arise to a sufficient level that it will be in the interest of the family for the parents to shift the credit. In this connection, it seems likely that the resulting irritation of the children and of their parents will immediately be redirected toward the tax law and the IRS. Dumb rules like this one must have a great deal to do with the taxpayer antagonism toward the payment of taxes that is currently giving the IRS such fits.

The second reason, however, is that the credit is worth more to the children than it is to the parent. In general, of course, credits are equally valuable to all taxpayers. However, there are several reasons why the education credits might be more valuable to the child than to the parent. Among these explanations, the two most likely are that the parent’s ability to claim the credit was limited by the $5,000 (or $10,000) ceiling on the Lifetime credit or, in the hands of the parent, the credit was subject to a phaseout. Shifting the credit to the child, therefore, will often be a tax planning device, undertaken for the purpose of avoiding the quite specific and deliberate limitations on the use of the credit that were inserted in section 25A. In this context the proposition is that Congress created a series of relatively strict limitations on the availability of the credit but then created a scheme through which those limitations could be avoided by well advised taxpayers but only if the taxpayer was willing to pay a toll charge in the nature of relinquishing the personal exemption for the student.

**When the effect of the phaseout of the deduction for the personal exemption is introduced into the equation, the scheme becomes utterly indefensible.**

Consider, for example, the simple case of a family whose children include 22-year-old twins who are both juniors in college. The parents are entitled to two personal exemptions with respect to those children, each producing a tax deduction of $756, and a Lifetime credit (in 2003) for educational expenses of $10,000, resulting in a credit of $2,000. However, each child has eligible expenses of $8,000, so education expenses of $6,000 are not creditable. Under the solution contained in the regulations, the parent may give up the personal exemption for one twin, in which event the parent will also lose a credit of $400 on the expenses of $2,000 attributable to that child. However, the child may now take a credit on all $8,000 of her expenses, which would be worth $1,600 — provided that the child has a sufficient income tax liability to absorb such a credit. If that income exists, the $1,600 credit available to the child will likely be worth more than the $1,176 ($400 plus $756) tax savings lost by the parent. Parents able to work out this result, therefore, would be well advised to “unclaim” one of the twins.

Such a scheme, whether deliberately designed or resulting from drafter inattention, would be objectionable on several grounds. (a) If the limitations on the availability of the credit are worth having, they should not be avoidable with the help of an accountant. (b) The scheme is complex and its existence means that to obtain maximum benefit from the education credits, taxpayers must be willing and able to engage in fairly sophisticated tax planning. Given the number of taxpayers affected by this provision whose tax returns otherwise would be generally uncomplicated, that result is highly unfortunate. (c) While a shift of the credit may increase the tax savings to the family, in many instances the forfeiture of the personal exemption is an excessive price for this benefit. However, when the effect of the phaseout of the deduction for the personal exemption is introduced into the equation, the scheme becomes utterly indefensible.

D. A Toll Charge Targeted at the Poor?

Losing the deduction for the personal exemption is a cost only if a taxpayer has the deduction at the start. Because the deduction is subject to one of the ever-present phase outs, not all taxpayers do have a deduction for personal exemptions to lose. Those taxpayers, accordingly, can shift the education credits to their children without the imposition of a toll charge. This interaction of the phaseout of the personal exemption with the phaseout of the education credits and the ability to shift that credit to the child produces a result that is plainly inconsistent with the expressed design of the new provisions.

On a joint return, the education credits are phased out for taxpayers having an AGI between $80,000 and $100,000. Below that level, parents may obtain a full benefit from the credit without shifting it to the children. After that income level is reached, however, the only way that any benefit can be obtained is if the credits can be shifted to the children.12 On the other hand, the deduction for the personal exemption begins to phase out on a joint return for 1998 when AGI reaches $189,950. Until that income level is reached, shifting the education credits to the child requires giving up the full tax benefit of the personal exemption. When AGI rises to $312,450, the personal exemption is entirely phased out. Accordingly, as income increases from about $190,000 to about $310,000, shifting the education credits to the child “costs” a decreasing amount. Ultimately, the resulting loss of the personal exemption costs nothing at all since that deduction has been completely phased out and is no longer there to lose. The result of all this, in round numbers, goes something like this: Taxpayers earning $125,000 can shift the HOPE credit of $1,500 to their children if they pay a toll charge of $800,13 which results in a net tax benefit from the credit of $700. Taxpayers earning

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12The same need to shift the credits can occur at lower income levels if the taxpayer encounters the ceiling on the Lifetime credit or one of the other limitations of the ability to benefit from the credits.

13The value of a $2,700 personal exemption to one in the 31 percent bracket, which begins at a taxable income of $104,050, is $837.
$250,000, entitled to only one-half the benefit of the personal exemption, can shift the credit at a cost of about $480, which results in a net benefit of $1,020. Taxpayers earning over $375,000 can shift the credit at no cost and thus the family as a whole will continue to derive a full tax benefit of $1,500 after the parents have shifted the tax credit to their children by foregoing the (nonexistent) personal exemption. Accordingly, as income rises, the value of the education credits that have been shifted to dependent children also rises. 

Imposing a reasonable toll charge on the transfer of the education credits to dependents may not be the best policy but it is not inherently irrational. However, imposing a toll charge that burdens only low- and middle-income taxpayers is. And imposing a toll charge but exempting high-income taxpayers from its scope is simply unacceptable. It follows that the elective scheme for shifting the education credit as developed in the proposed regulations is not acceptable. 

The ability of high-income taxpayers to shift the education credits to their children cost free has further implications. While on the face of section 25A it appears that the benefit of the education credits is phased out as income rises, that turns out to be illusory. To the extent that the education credits can be shifted to other members of the family, such as the student in question, without a loss in value, the actual benefit from those credits has not been phased out. Such a shift of the benefit of the credits can occur if (a) the student is treated as paying his or her own education expenses even though he or she does not, (b) the student is entitled to claim the education credit, (c) the student has a sufficient tax liability to absorb the credit, and (d) the parent is not subject to any penalty on yielding the credit to the student. As discussed above, all those requirements are readily met under the proposed regulations for very-high-income families. Accordingly, the apparent phaseout of the education credit has no practical application to high-income taxpayers. Rather, the phaseout of the education credits applies only to the category of taxpayers whose AGI falls between $80,000 (the start of the phaseout of the education credits on a joint return) and $312,000 (the end of the phaseout of the personal exemption). 

V. Toward a Better Approach

The drafters of section 25A did not need to develop a new scheme for allocating the tax benefit from the payment of expenses of dependent children. This issue has been addressed under the code since the inception of the income tax in a manner entirely consistent with fundamental principles of taxation. Under the general scheme of the tax law, children, including minor dependent children, are taxpayers in their own right, entirely distinct from their parents. If their income achieves the same levels applicable to adults, they are required to file their own income tax returns, reporting their own income and claiming their own deductions.14 While authorities are scant, it is firmly established that when the child pays its own expenses, whether personal or business-related, the child, and only the child, can deduct those expenditures regardless of whether the source of the payment is the child’s own funds or funds supplied by the parent.15 Indeed, absent specific statutory authority, even where the parent pays expenses of the child, the deduction for those expenses belongs to the child and cannot be claimed by the parents.16

The code section that would seem to contains the closest analogy to education expenses is section 213 which grants a deduction for medical expenses. Under that section, like section 25A, a taxpayer is entitled to a deduction for medical expense of the taxpayer, his or her spouse, and of any dependent paid by the taxpayer. Thus, where a parent pays the medical expense of a dependent child, the parent, by virtue of this specific statutory provision, is entitled to deduct the payment. However, if the child pays its own expenses, the deduction is not attributed to the parent. Rather, the deduction must be claimed by the child and may not be claimed by the parent. In short, each taxpayer, parent or child, deducts the expenses they pay — and only the expenses they pay. 

Initially, section 25A should be amended to delete the mistreatment of dependent children contained in subsection (g)(3) and to replace that rule with the traditional approach currently applied to medical expenses. If the amendment stopped at that, all taxpayers would be able to avoid the ceilings and phaseouts that under current law only high-income taxpayers can avoid. That alone would be an improvement. To go beyond that point and seek to apply the limitations on the availability of the credit applicable to the parent to the disbursements of the child will require careful considerations. However, this sow’s ear. Indeed, it may have made matters worse. The unavoidable conclusion, therefore, is that the collection of education assistance provisions deserves more serious congressional attention.

VI. Conclusion

The education assistance provisions enacted in 1997 were quite poorly constructed. They produce an endless series of harsh or foolish results, one of which is outlined here. In a decent attempt to correct some of the worst features of the statute, the proposed regulations have offered some creative interpretations of section 25A. But, acting within the limits of the regulatory process, the Treasury cannot make a silk purse out of this sow’s ear. Indeed, it may have made matters worse. The unavoidable conclusion, therefore, is that the collection of education assistance provisions deserves more serious congressional attention.

14 IRS, Tax Rules for Children and Dependents (Pub. 929), p. 4, and Bittker & McMahon, Federal Income Taxation of Individuals, para. 34.5[3].
15 GCM 33678 (Nov. 6, 1967).
17 Under section 1(g) the unearned income of a child under the age of 14 is taxed at a rate geared to the income of the parent. However, in general this income and any related expenses remain reportable by the child. To that rule, section 1(g)(7) provides a highly restricted election to report minor amounts of the investment income of a child directly on the tax return of the parent.