President Obama unveiled several higher education proposals in his State of the Union Address of 2015, including several changes in the tax code. The proposals include consolidating and simplifying the existing system of higher education tax credits and changing the taxation of student loan interest and forgiveness. A proposal to reduce the tax benefits of educational savings plans has been eliminated.

AMERICAN OPPORTUNITY TAX CREDIT

The current system of six higher education tax credits will be reduced to an expanded and permanent American Opportunity Tax Credit. The AOTC is set to expire in 2017. The proposal would have it replace Hope and Lifetime Learning Tax Credits as well as the tuition and fees deduction, among others.

- The revamped AOTC would increase to a maximum of $2,500, and the refundable portion of the credit (which students would receive even if they did not have a tax liability to offset) increase to $1,500. The credit will be indexed to inflation.
- To support non-traditional students, students attending less than half-time would be allowed to claim up to $1,250, with $750 refundable. All students would be able to claim the AOTC for up to five years, an additional year over the current AOTC.
- Pell Grants would be exempted from both income taxation and AOTC calculation.
- Institutions would be required to provide students with the tuition and fee information needed to claim the AOTC.

The proposed changes would likely have minimal effect on institutions. Research suggests that tax credits do little to change decisions on whether to pursue higher education; those who cannot afford higher education are rarely in a position to wait until the following tax season for up-front costs to be offset by tax savings.

STUDENT LOAN TAXATION

Currently, interest on federal direct and indirect guaranteed loans is deductible. The introduction of various income-based repayment options reduces payments for borrowers to 10% of their disposable income, but any amount forgiven at the end of the repayment period is taxable. The result can be a perverse incentive for participation, with additional years of manageable payments being replaced by an immediate tax liability of a substantial portion of the outstanding balance.

- The proposed changes would eliminate taxability of forgiven loan balances for the Pay-As-You-Earn payment program after the 20 year repayment period.
- The student loan interest deduction would be eliminated for new borrowers, but would continue in place for existing loans.
These proposed changes would likely have minimal effects on both institutions and current students. They do not directly affect current students, most of who are eligible for in-school loan deferments. These do marginally change benefits that may incentivize borrowing to the extent that students are aware of these post-enrollment tax benefits, but most research suggests that awareness of the tax implications of student finance is minimal. The changes would make income-based repayment plans more effective in reducing burdens from student borrowing.