End the Taxation of Pell Grants and Alter Related Policies to Help Needy Community College Students

Community colleges strongly support two related changes that fall under the jurisdiction of the House Ways and Means and Senate Finance Committees:

1) Make Pell Grants entirely non-taxable to help low- and lower-middle income students retain more of their grant support, thereby reinforcing the program's goals; and,
2) Enable community college students to better access the $2,500 American Opportunity Tax Credit (AOTC) by eliminating the Pell Grant offset.

Issue Background

Taxation of Pell Grants

Under current law, Pell Grants are subject to taxation, due to their classification as "scholarships" under Section 117 of the IRS code. This provision requires taxation of any funds received by a student to pay for expenses beyond tuition, fees, and limited required expenses. It is probable that Congress did not fully deliberate upon the taxation of cash grants provided to low-income students when the program was created, since Pell Grants have never been thought of as "scholarships"; they are rigorously means-tested and based solely on income.

Nevertheless, taxing Pell Grants has had a harsh financial impact on the lowest-income community college students. The students are generally the only students in higher education with grants that exceed their tuition, therefore subjecting them to taxation. As of July 1, 2022, the maximum Pell Grant award will be $6,895, while the average full-time, full-year community college tuition and required fees in the fall of 2021 was $3,800. This means that, on average, a community college student receiving the maximum grant may have almost $3,000 of that award subject to federal tax.

Pell Grant recipients are the neediest students in higher education and all funds must, by law, be used to cover a student's "cost of attendance." Subjecting any portion of their grants to taxation can only serve to undermine student success and the basic purpose of the Pell Grant program. More than two million community college students receive Pell Grants each year, and the program is a lifeblood of student retention, completion, and success. Its tax status must be changed so that students who choose a low-cost college can receive the benefits of their grant, rather than giving some of the funds back to the government.

American Opportunity Tax Credit

Additionally, the interaction of the eligibility structure of the American Opportunity Tax Credit (AOTC) with the Pell Grant program disadvantages community college students and should be changed. The AOTC provides a maximum tax credit of $2,500 a year to college students and their parents. It pays for “qualified tuition and related expenses” (or QTRE), which includes tuition, required fees, and course materials, for four years. The AOTC covers 100 percent of the first $2,000 of QTRE and 25 percent of the next $2,000. Therefore, students need $4,000 of eligible expenses to fully qualify for the credit. However, AOTC eligibility is offset by any “non-taxable” grant assistance that a student receives. Therefore, if a community college student pays $4,000 for tuition expenses and receives a $4,000 Pell grant, they do not qualify for any portion of the AOTC. In contrast, parents who earn $160,000 annually and spend $35,000 on their child’s tuition receive the full $2,500 credit. An independent student who attends a public four-year university and who receives the maximum Pell Grant award, and pays the average tuition of $10,740, would also receive a $2,500 AOTC.

It makes little sense and is highly inequitable to allow families with incomes of up to $180,000 annually to receive a full $2,500 AOTC, while a community college Pell Grant recipient, with large amounts of unmet need, receives nothing. Therefore, in making Pell Grants non-taxable, the AOTC statute should be changed to exclude Pell Grants from being counted against a student’s eligibility. The elimination will better align the Pell Grant program with the AOTC, since both benefits could then be used for all expenses allowable under the Title IV cost-of-attendance rules. The American Council on Education (ACE) estimates that the change would benefit more than 700,000 financially needy students.

Legislative Background

Ending the taxation of Pell Grants and reforming the AOTC to make it work better for community colleges has had longstanding support, and a variety of bipartisan bills to address these issues have been introduced in Congress. The legislation has received the support of a broad array of higher education groups.

H.R. 4173, the “Tax Free Pell Grant Act,” was introduced on a bipartisan basis by Representatives Lloyd Doggett (D-TX) and Mike Kelly (R-PA) in early 2021. A version of that legislation was included in the House Fiscal Year 2022 budget reconciliation legislation. The legislation had a cost estimate of $1.9 billion over ten years. Nineteen higher education organizations, led by ACE, supported the provision. A similar version of the “Tax Free Pell Grant Act” was introduced in the Senate by Sheldon Whitehouse (D-RI), S. 2455.

Bipartisan legislation to make Pell Grants non-taxable was also introduced in the House of Representatives in the 116th Congress (H.R. 3803) by Mark DeSaulnier (D-CA), and garnered widespread endorsement from stakeholders. Further back, broadly supported bipartisan legislation, H.R. 3394, was passed by the House of Representatives in 2014 as part of that chamber’s work on tax reform.

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