AMERICAN ASSOCIATION OF COMMUNITY COLLEGES
LEAD ADVOCATE ADVANCE

End the Taxation of Pell Grants and Help Lower-Income Community College Students Access the American Opportunity Tax Credit (AOTC)

Community colleges urge the enactment of two related changes under the jurisdiction of the House Ways and Means and Senate Finance Committees:

- 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,
- Enable community college students to better access the $2,500 American Opportunity Tax Credit (AOTC) by eliminating the Pell Grant offset.

Taxation of Pell Grants

Under current law, Pell Grants are subject to taxation due to their classification as "scholarships" under the IRS code. Students are taxed on any Pell Grant funds used to pay for expenses beyond tuition, fees, and limited required expenses. This tax treatment undermines the Pell Grant program's purpose as a rigorously means-tested benefit that, under the Higher Education Act (HEA), can only be used for education-related expenses.

Taxing Pell Grants has had a harsh financial impact on the lowest-income community college students. Because of low community college tuition, these students are generally the only students in higher education with grants that exceed their tuition, subjecting a portion of the Pell Grant award to income tax. For the 2022-23 award year, the maximum Pell Grant award is $6,895, while the average full-time, full-year community college tuition and fees was just $3,800. On average, then, a community college student receiving the maximum Pell Grant may have more than $3,000 of that award subject to federal tax.

Subjecting any portion of these need-based grants to taxation limits the program's impact and undermines student success. 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 grant's full benefit, rather than returning some of those needs-based funds to the government.

American Opportunity Tax Credit

The tax treatment of Pell Grants interacts with the eligibility rules for the $2,500 American Opportunity Tax Credit (AOTC) to commonly deny community college students who receive Pell Grants the benefit, even though their need is far greater than millions of other college students who qualify. Under the AOTC eligibility formula, any Pell Grant amount received is subtracted from the tuition and qualified expenses that the AOTC covers. For example, if a low-income community college student pays $4,000 tuition and receives a $4,000 Pell grant, they do not qualify for any AOTC, even though the Pell Grant can cover transportation, living expenses, and other costs that the AOTC does not. In contrast, a student who receives that same $4,000 Pell Grant, and pays the average public four-year in-instate tuition of $10,740, would also receive a maximum $2,500 AOTC, because of their higher tuition. Both students have educational costs that far exceed $4,000, but only the low-income four-year student qualifies for the $2,500 AOTC. At the same time, far more affluent students who do not come close to qualifying for a Pell Grant receive the $2,500 AOTC.

It makes little sense and is highly inequitable to allow families with incomes of up to $160,000 annually to receive a full $2,500 AOTC, while a community college Pell Grant recipient, with thousands of dollars 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, which is caused by the current tax treatment of Pell Grants. The American Council on Education (ACE) estimates that the change would benefit more than 700,000 financially needy students.

Ending the taxation of Pell Grants and reforming the AOTC to make it work better for low-income community colleges has had longstanding support, and a variety of bipartisan bills to address these issues have been introduced in Congress. The legislation has also 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 similar version of the "Tax Free Pell Grant Act" was introduced in the Senate by Sheldon Whitehouse (D-RI), S. 2455.

Community colleges seek enactment of The Tax-Free Pell Grant in 2022. All legislators should support this common-sense, low-cost legislation that will improve existing higher education assistance programs to better reach the students who need the most support.

For more information, please contact AACC Senior Vice President of Government Relations David Baime (dbaime@aacc.nche.edu) or Associate Vice President of Government Relations Jim Hermes (jhermes@aacc.nche.edu).