Make Pell Grants Tax-Free and Help Community College Students Qualify for the AOTC

Community colleges are in a strong position to make Pell Grants non-taxable and to ensure that needy community college students have effective access to the $2,500 American Opportunity Tax Credit (AOTC).

The bipartisan legislation community colleges enthusiastically support is the *Tax Free Pell Grant Act*. It would end the need for community college students to pay taxes on the portion of their Pell Grants used for expenses beyond tuition and required fees. The bill would also alter the eligibility formula for the $2,500 AOTC credit in ways that will enable Pell Grant recipients who attend community colleges to receive the credit—currently, many do not. Both these issues stem from the relatively low tuitions provided by community colleges.

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.

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 2023-24 award year, the maximum Pell Grant award is $7,395, while the average full-time, full-year community college tuition and fees was just $3,860 for the 2022-23 academic year. On average, then, a community college student receiving the maximum Pell Grant may have more than $3,500 of that award subject to federal tax.

Almost two million community college students receive Pell Grants each year, and the program is a lifeblood of student 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. 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 in tuition and receives a $4,000 Pell Grant, they do not qualify for any AOTC amount, 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 receive the maximum $2,500 AOTC because of their higher tuition cost. Furthermore, there is strong evidence that the complicated tax treatment of Pell Grants results in sub-optimal filings.

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.

Legislative Vehicles

These common-sense changes outlined above are included in H.R. 3000, the *Tax Free Pell Grant Act*, introduced on a bipartisan basis by Representatives Lloyd Doggett (D-TX) and Mike Kelly (R-PA) in the 118th Congress. All Representatives should be encouraged to support this legislation.

A similar version of the *Tax Free Pell Grant Act* was introduced in the Senate by Sheldon Whitehouse (D-RI), in the 117th Congress. Senate reintroduction on a bipartisan basis is expected to occur in early fall 2023. As in the House, all Senators should be encouraged to lend their support.