



Off to School:

Tax Breaks for Education

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For many students (and their families) the question regarding higher education is not just “what college or graduate school will I attend?” but “how are we going to pay for this?”

Whether you’re a parent, a working individual thinking about getting a degree, or someone making plans now to save for education down the road, it is never too late to start thinking about and preparing for educational costs.

The IRS offers some valuable tax breaks that make planning and saving for education easy on your wallet. Some of these breaks are very attractive because they do not limit participants based on income levels and anyone can join in. There is a wide mix of options, with potentially something for everyone.

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This guide provides a rundown of some tax-wise ways of covering education costs. You’ll learn about:

- Education Tax Credits
- Deducting Higher Education Expenses
- Scholarships
- Credits And Deductions
- Student Loan Interest Deduction
- Education Savings Accounts
- 529 Plans
- Employer Educational Assistance
- Tax-exempt Bonds
- UGMA Brokerage Accounts
- Using Retirement Savings For Education

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Education Tax Credits

Two tax credits can be used for education after high school. They are the HOPE scholarship credit and the Lifetime Learning credit. The credits can help with the costs of tuition and fees. Generally, they don't cover books, room and board and other expenses. Many people qualify for one or both of the credits but both carry income limits. The limits are different if you are single or married. If you are single, your income cannot be higher than \$55,000 in 2006 (your credit is reduced starting at \$45,000). If you are married, your income cannot be higher than \$110,000 in 2006 (your credit is reduced starting at \$90,000).

Caution. The credits are not available to married couples who file separate returns.

Most taxpayers find that the full amount of the credit can usually be covered by tuition costs alone. The HOPE credit can reach \$1,650 and the Lifetime Learning credit can reach \$2,000.

Who's eligible for these credits:

- You
- Your spouse or
- Your dependents

Here's a side-by-side profile of the features of the two credits:

HOPE Scholarship credit

Gives a \$1,650 maximum allowable credit per student for each of the first two years of education beyond the high school level.

Gives a 100 percent credit per eligible student for the first \$1,100 of tuition and a 50 percent credit for the second \$1,100 of tuition. A student has to be enrolled on at least a half time basis for at least one academic period during the year.

Lifetime Learning credit

Gives a credit of 20 percent of qualified tuition expenses a taxpayer pays for any year the HOPE credit is *not* claimed.

The maximum credit equals 20 percent of the first \$10,000 of tuition incurred during the tax year for education beyond high school, including courses to get or improve job skills.

Income phaseout amounts

The maximum HOPE credit is allowed *per student*. The Lifetime Learning credit maximum is calculated *for each taxpayer* and doesn't change based on the number of students in your family.

Unfortunately, the income level that can disqualify you from claiming an education credit is not increased based upon the number of eligible students in your family.

Deduction No Longer Available

Beginning in 2006, the above-the-line education deduction Congress had enacted in 2002 is no longer in effect, unless Congress acts to extend it. Other valuable education incentives may be available to you, however, so be sure to follow up with your trusted tax professional.

Scholarships

If you receive a scholarship, it may or may not be included in your income depending upon the terms of the scholarship. A scholarship—whether need-based or for academic or athletic abilities—generally will *not* be included in your income if:

- You are pursuing a degree at an educational organization; and
- You use the scholarship for tuition and certain expenses.

Caution. If you receive a scholarship as payment for research, teaching, or other services, then these payments may be taxable income.

Qualification requirements

To be considered as someone who is “pursuing a degree,” you have to receive a scholarship for study at an educational institution meeting certain requirements. Besides students attending either primary or secondary schools, or students at a college or university



Planning tip. There is no gift tax, ever, when you pay someone else’s tuition. In technical speak, you get an “unlimited exclusion” from the gift tax for amounts that you pay for someone else’s school tuition, as long as the payment is made directly to the school. You and the other person do not need to be related and this exclusion is available on top of the annual \$12,000 gift exclusion. Remember, however, that this exclusion is for tuition only, not for room and board. Payment to a foreign university isn’t covered either.

pursuing a degree—you will be considered a full or part-time student pursuing a degree if you receive a scholarship to study at an educational institution that is:

- Acceptable for full credit toward a bachelor’s degree or a higher degree or is a training program preparing students for gainful employment in a recognized occupation;
- Government authorized; and
- Accredited.

Example. You are a scholarship student at a technical school studying aircraft maintenance. The school has state authorization and is also accredited. You qualify as a person pursuing a degree and you can exclude, from your gross income, your scholarship.

Caution. Only the portion of your scholarship that you use to pay tuition, fees, supplies, equipment, and books is excluded from your income. Room and board isn't excluded.

CREDITS OR DEDUCTIONS—WHICH IS BEST?

There is no “double-dipping” when claiming education tax breaks. If you receive a tax-free scholarship, you can't claim the expenses covered by the scholarship as expenses eligible for a tax credit or a deduction.

If you are paying for an education expense out-of-pocket, you should remember that payment can take a variety of forms: cash, credit card, a distribution from an education IRA, and even the type of “financial aid,” which represents a loan with a reduced interest rate. Also, look at your tax bracket.

Deductions: A deduction decreases adjusted gross income (AGI), which in turn is used to regulate the amount of other, “itemized deductions” such as the medical deduction.

Credits: A credit decreases your bottom-line tax bill—dollar for dollar. For most people, this brand of tax reduction beats having an equal amount as a deduction hands down—but only if the same amount of expense would qualify as an either-or choice. Usually, you'll need to decide between a deduction having a higher dollar amount and a credit with a lower dollar value.

Example. You are in the 25 percent tax bracket. You have a choice between claiming a \$1,000 deduction or a \$250 tax credit. Which one should you take? You will save \$250 ($\$1,000 \times 25\%$) in taxes, taking the deduction. If you claim the credit you will save \$250, too. If you have any deductions dependent on adjusted gross income, however, taking the education expense deduction may make the most sense. On the flip side, if you are in the 15 percent tax bracket, you would only save \$150 ($\$1,000 \times 15\%$) by taking the deduction so you would be better off claiming the \$250 credit.

Student Loan Interest Deduction

If you have to borrow money to pay for school, you'll be happy to know that an above-the-line deduction for up to \$2,500 is allowed annually for interest on education loans. The old rule limiting the interest deduction to only the first 60 months that interest payments are required has been eliminated.

What loans qualify?

Any debt for paying the higher education expenses of:

- You
- Your spouse or
- A person who was a dependent when the debt was incurred

Caution. If you are claimed on someone else's tax return as a dependent, then you cannot claim the student loan interest deduction. In addition, only the person who is liable for the loan can deduct the student loan interest. For example, if your child takes out a loan to pay for her college expenses, only your child can deduct interest on the loan, even if you pay the interest.

Income phaseouts

Not everyone can take the student loan interest deduction. Eligibility depends on your income.

- You can take the student loan interest deduction so long as your income is below \$50,000 for single people and \$100,000 for married couples filing jointly. If your income is higher, the credit phases-out. The deduction is phased out for individuals having modified adjusted gross incomes between \$50,000 and \$65,000.

- For married couples filing jointly, the deduction is phased out for those with modified adjusted gross incomes between \$100,000 to \$130,000.

Education Savings Accounts (Formerly Education IRAs)

Education savings accounts – officially known as Coverdell Education Savings Accounts – are another way to save and pay for education. To get real tax savings, you have to plan long in advance of when you'll need the money. It is wise to start this sort of account at least five years before you intend to use it; starting when the student is an infant is even better.

Coverdell Education Savings Accounts are very taxpayer-friendly. The account balance is never taxed, not even to the student, when it is used for education expenses. You can save up to \$2,000 every year.

Coverdell Education Savings Accounts can be used not only for college costs but also for elementary and secondary school education expenses. The student can attend a public, private or religious school. Eligible expenses include, among other things, tuition, fees, books, and room and board.

You can also rollover money you had saved in an old education IRA into a Coverdell Education Savings Account. Education IRAs have been phased-out by Coverdell Education Savings Accounts.

Income phaseouts

Education Savings Accounts have higher income phaseouts :

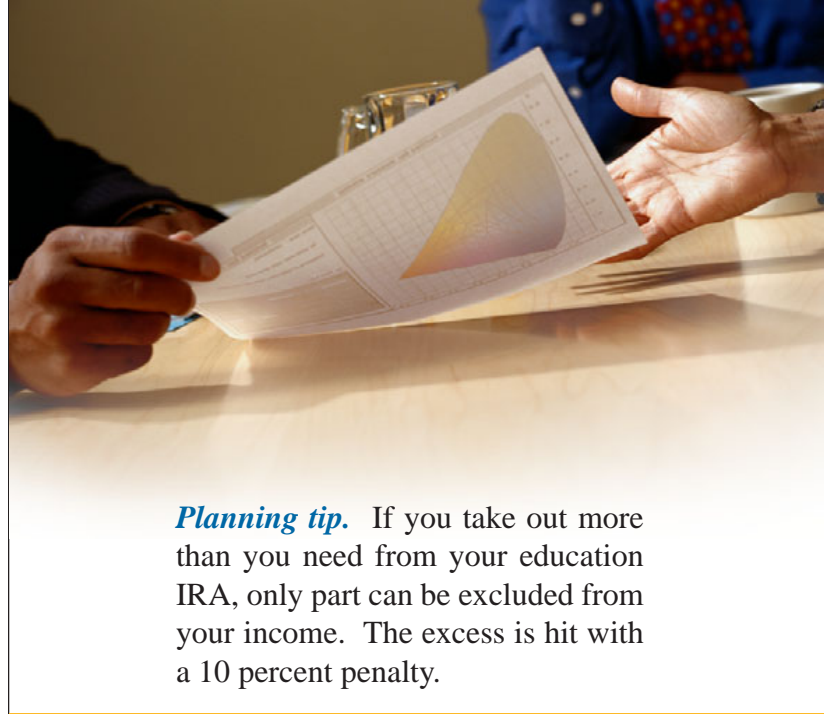
- The contribution limit is phased out for married couples filing jointly with adjusted gross incomes between \$190,000 to \$220,000.
- The phaseout range for single people is \$95,000 to \$110,000.

What if I cannot use an education savings account?

If your adjusted gross income is too high to qualify for an education savings account, you could ask a relative or friend, whose adjusted gross income is lower, to make the contributions. You could also give the money to the beneficiary as a gift and then have him or her make the contributions.

529 Plans

Section 529 plans are very popular. You've probably seen the ads in newspapers and magazines.



Planning tip. If you take out more than you need from your education IRA, only part can be excluded from your income. The excess is hit with a 10 percent penalty.

They've been around for awhile but two years ago Congress made some very important and valuable changes to them. Many more people can take advantage of 529 plans and save for higher education. Unlike other education tax incentives, there are no income phaseouts!

There are two types of 529 plans. One is known as a "qualified tuition program," a "prepaid tuition program" or a "guaranteed tuition program." The other type of 529 plan is a savings account.

Prepaid/qualified tuition programs

The first type of 529 plan lets you save for a child's education by paying a lump sum or a monthly installment to a trust operated by your state, then naming the child as the beneficiary. What you're doing is paying for future tuition at today's prices.

Caution. Some states do not guarantee the contract, so there is a risk the trust fund could become insolvent.

Caution. Using a prepaid tuition program can reduce a student’s eligibility for aid such as subsidized loans, work-study, or certain grants. The federal government considers prepaid tuition as a resource reducing a student’s financial need on a dollar-for-dollar basis.

Distributions from a *state* prepaid tuition program are tax-free so long as they are used for qualified education expenses. That means tuition, supplies, equipment, and books.

Contributions generally are treated like gifts. For example, a \$50,000 lump sum contribution can be treated as if made over a five-year period.

Savings account plan

The second type of 529 plan lets you make contributions to a state-managed savings account for the benefit of a beneficiary you designate. There are usually a number of investment options. Typically, you can use the money you save to pay for out-of-state schools as well as in-state schools.

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529 savings plans are similar to Coverdell Education Savings Accounts but have some important differences. Here’s a rundown:

Section 529 savings plans

Earnings accumulate with taxes deferred and subject to no tax as long as they are used for educational expenses after high school.

Qualifying expenses include tuition, books and equipment, room and board, fees, and services for special needs.

No income phaseouts, so individuals of all income levels can participate.

Contributors may receive state tax breaks if they have income in the state where the plan is located (regardless of whether the beneficiary is a dependent).

The state chooses the plan administrator (fund company), which selects the investment options available and sets fees.

Coverdell Education Savings Accounts

Qualifying distributions are tax-exempt.

You can use this account for for elementary, secondary, and higher education expenses.

The contribution limit is phased out for single people with adjusted gross incomes between \$95,000 to \$110,000 and for married couples filing jointly with adjusted gross incomes between \$190,000 to \$220,000.

Two years ago, Congress gave investors more control over their investments in savings account plans. It’s easier to move your savings from an under-performing plan to a more aggressive one.

Caution. Contributing to a 529 plan will not guarantee the beneficiary’s admission to any school.

Employer Provided Educational Assistance

If your employer helps with education expenses, you may be able to exclude from your income up to \$5,250 in employer provided educational assistance. You can now use employer provided educational assistance for graduate school. Also, courses covered by your employer's program don't always have to relate to your job.

Savings Bonds

US savings bonds are a popular way to save for education expenses and have some tax advantages. They are easy to buy and a safe investment because they're backed by the United States government. However, a child can't purchase a bond for his or her eventual use.

Caution. When savings bonds are redeemed to pay expenses for higher education, the interest may be excluded from your income if your income is below a certain range. For 2006, the phaseout range begins at \$78,100 modified AGI for individual filers and at \$124,700 for married couples filing jointly.



Planning tip. If you take full advantage of your employer's program and exclude \$5,250 from your income, how much tax savings you'll get depends upon your tax bracket. If you are in the 25 percent tax bracket then your tax savings will be \$1,312.50 ($\$5,250 \times 25\%$) more than if you merely received a salary increase of \$5,250.

You can redeem savings bonds to make contributions to an Education Savings Account or a qualified tuition program without incurring tax consequences.

Higher educational expenses for tax purposes are tuition and fees required for enrollment or attendance of you, your spouse or your dependent at any eligible educational institution. Eligible educational institutions include most public and nonprofit colleges, universities and vocational schools.

UGMA Brokerage Accounts

If you don't want to lock funds into a 529 plan and your income is too high to take advantage of other tax-friendly savings vehicles, you should consider a Uniform Gift to Minors account (UGMA).

You can give your child up to \$12,000 every year tax-free (\$24,000 if you and your spouse "split" each gift). You don't have to contribute the maximum each year. You can contribute enough just to cover tuition. However, and this is a big concern for many parents, once your child turns 18, he or she can take the money and use it for anything, not just education.

The success of a UGMA depends on how you invest the money. Since investment earnings of a child under age 14 are taxed at his or her parents' marginal rate under the so-called "kiddie tax," the account must have as little taxable earnings as possible until the child turns 14.

You can invest in stocks with low dividends and high potential appreciation. Since the gains are not taxed until the stock is sold, a UGMA would hold and continue to invest in stock until the child turns 14, at which time the stock would be sold slowly over the course of the next three to four years, at the child's low capital gain tax bracket rates.

Example. You give your daughter stock valued at \$11,000 when she is two years old. If the shares are worth \$75,000 when she turns 14, you can have the shares sold for her gradually over the next three or four years and be taxed on the \$64,000 gain at her low eight percent long-term capital gain rate.

Withdrawing From Retirement Savings

Don't withdraw money from a retirement savings plan unless you're using it for retirement. That said, there are some very limited exceptions. Paying for higher education is one important exception.

You can use the money you saved in a retirement plan to pay for qualified higher education expenses. You can pay for tuition, fees, books, supplies and equipment. Room and board is also a qualified expense.

You can use your savings to pay for your educational expenses or the expenses of your spouse, child, or grandchild.

Not tax-free

To take money out of an Individual Retirement Account, all you need to do is show that a qualified higher education expense exists. For some retirement plans, however, the payout must also qualify as a hardship distribution. In either case, the distribution is not tax-free. It is added to your income and is taxed at your highest marginal income tax rate. The good news is there's no penalty.

Some retirement plans allow participants to borrow against their savings. This may be another way to find short-term funds to pay for your child's college education, but be careful. If you pay back the loan, with interest, within five years, you don't pay tax. If you don't repay the loan, tax and penalties are due – a hefty price to pay if you have other options.

Conclusion

The variety of education tax incentives makes it possible for everyone to take advantage of one or more of them to help finance educational costs. Many of the tax incentives can be combined to maximize the growth of your savings and minimize taxes. Your tax professional can help you create an education strategy using these tax incentives to their fullest.