

AN OVERVIEW OF TAX BENEFITS FOR EDUCATION PLANNING

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ABSTRACT

The cost of a college education is expensive and rising. With diligent and vigilant planning, tax benefits can provide some relief from the high cost of college. The purpose of this article is to provide an overview of tax benefits available for education planning. Whether a taxpayer can take advantage of the credits, deductions, and savings programs described in this article depends on the taxpayer's individual facts and circumstances. Equipped with knowledge about the availability of tax benefits, a taxpayer in conjunction with a financial adviser should be able to develop a plan to mitigate the impact of education expenses.

INTRODUCTION

The cost of a college education is expensive and rising. With diligent and vigilant planning, tax benefits can provide some relief from the high cost of college. The Taxpayer Relief Act of 1997 (TRA 1997) and the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRA) enacted several tax benefits for education. Specifically, TRA 1997 added provisions for the Hope Credit and Lifetime Learning Credit, a deduction for student loan interest, and Education Individual Retirement Accounts (Education IRAs).

TRA 1997 also eliminated the early withdrawal tax on certain IRA withdrawals and set the requirements for tax-exempt status for qualified tuition programs (QTPs). Provisions of the EGTRA included creation of an above-the-line tax deduction for higher education tuition and related expenses, elimination of the 60-month limit on the student loan interest deduction, a raise in the annual contribution limits on education IRAs, and tax-free withdrawals from QTPs. In this article, for the purpose of providing an overview for education planning, the tax benefits are categorized as credits, deductions, and savings programs.

CREDITS

A tax credit results in a dollar-for-dollar reduction in the tax liability. Credits create the same tax reduction for all taxpayers. There are two tax credits for education available based on tuition and required enrollment expenses incurred by students pursuing college or graduate degrees or vocational training. The Hope credit and the Lifetime Learning credit are nonrefundable credits so a taxpayer can only use the credits to reduce the taxpayer's income tax liability to zero. This election is separate for each student so a parent may elect to take the Hope credit for one child and the Lifetime Learning credit for another child. The allowable amount of the credits is reduced for taxpayers who have modified adjusted gross income (MAGI) above certain amounts. (MAGI is defined generally as adjusted gross income plus certain excluded foreign income.) To claim the credit, married couples must file a joint return, unless the special rules for married individuals who are separated or living apart apply.

The credits are available for payment of qualified tuition and related expenses that cover an academic period beginning in the same calendar year as the year in which payment is made. However, an individual can claim the credits for qualified expenses paid in the calendar year to cover an academic year that begins in January, February, or March of the following year.

Hope Credit

During the freshmen and sophomore years of postsecondary education, taxpayers may want to consider the Hope credit. The Hope credit is for 100 percent of the first \$1,000 of tuition and required enrollment fees and 50 percent of the next \$1,000—or a maximum of \$1,500 per student. The credit is applicable to the taxpayer, spouse, and dependents. In a given tax year, a taxpayer can not claim the Hope credit if the Lifetime Learning credit or an above-the-line deduction for higher education is claimed for the same student. Table 1 summarizes the provisions for the Hope credit.

Table I: Current Tax Credit Provisions		
	<i>Hope Credit</i>	<i>Lifetime Learning Credit</i>
Applicable IRC Section	25A	
Benefit	Can reduce amount of tax payable	
Annual Limit	\$1,650 credit per student	\$2,000 credit per family
Income Phase Out	\$45,000 - \$55,000 \$90,000 - \$110,000 for joint returns	
Qualifying Expenses	Tuition and required enrollment fees	
Qualifying Education	First two years of undergraduate (postsecondary)	Undergraduate and graduate Courses to acquire or improve job skills
Other Conditions	Can be claimed for only two tax years Must be enrolled at least half-time in degree program No felony drug convictions	
Source: EGTRA [2001]; IRS [2006]; TRA [1997]		

Lifetime Learning Credit

Unlike the Hope credit, the Lifetime Learning credit is not limited to students in the first two years of postsecondary education. Also, unlike the Hope credit, the Lifetime Learning credit is not based on the student's work load, therefore, it is allowed for one or more courses. Qualified expenses for graduate-level degree work are eligible. For each eligible student, there is no limit on the number of years for which the Lifetime Learning credit can be claimed. The Lifetime Learning credit enables taxpayers to claim up to \$2,000 (20 percent of up to \$10,000 of tuition and required enrollment fees). The amount a taxpayer can claim as a lifetime learning credit does not vary (increase) based on the number of eligible students for whom the taxpayer pays qualified expenses. It is computed on a per-taxpayer basis. The provisions for the Lifetime Learning credit are summarized in Table 1.

DEDUCTIONS

There are two provisions for above-the-line deductions, which are deductions for adjusted gross income (AGI). The student loan interest deduction and the deduction for qualified higher education (tuition and fees) expenses allow taxpayers to take a deduction for education expenses without itemizing or being subjected to the "miscellaneous itemized deductions" limitation. Each deduction is subject to a phase out range.

Student Loan Interest Deduction

There is a special deduction allowed for paying interest on a student loan used for higher education. Only the person legally obligated to repay the loan can claim the deduction. If the student took out the loan in his/her own name, then he/she can claim the deduction, not the parent who offers to make the payments for the child. Interest paid on loans from most sources, government or private, qualify, except for loans from related parties such as parents, grandparents, spouse, children, or certain controlled business interests.

To qualify for this deduction, many rules must be met. No deduction is allowed to an individual who can be claimed as a

dependent on another taxpayer's return. Married couples must file jointly to take the deduction. Qualified expenses must be reduced by nontaxable scholarships and education assistance. The loan must have been used for qualified higher education expenses paid or incurred within a reasonable period before or after the indebtedness was incurred. The provisions for the student loan interest deduction are summarized in Table 2.

Tuition and Fees Deduction

The tax year 2005 was the last year that taxpayers were scheduled to be allowed to claim a tax deduction for qualified higher education expenses. However, this deduction has been extended through 2007. This is a per-return deduction so the maximum is calculated regardless of the amount paid or the number of dependent students paying tuition. In addition, the deduction can not be claimed if the Hope or Lifetime Learning credits are claimed for the same students.

Table 2: Current Tax Deduction Provisions		
	<i>Student Loan Interest Deduction</i>	<i>Tuition and Fees Deduction</i>
<i>Applicable IRC Section</i>	221	222
<i>Benefit</i>	Can deduct interest paid	Can deduct expenses
<i>Annual Limit</i>	\$2,500 deduction	\$4,000 deduction
<i>Income Phase Out</i>	\$50,000 - \$65,000 \$105,000 - \$135,000 for joint returns	\$65,000 - \$80,000 \$130,000 - \$160,000 for joint returns
<i>Qualifying Expenses</i>	Tuition and required enrollment fees Books, supplies, and equipment Room and board Transportation Other necessary expenses	Tuition and required enrollment fees

Table 2: Current Tax Deduction Provisions		
Qualifying Education	Undergraduate and graduate	
Other Conditions	Must have been at least half-time student in degree program	Cannot claim both deduction and education credit for same student in same year
Source: EGTRA [2001]; IRS [2006]; TRA [1997]		

Qualified expenses must be reduced by amount of any non-taxable payments received for education. Examples of non-taxable payments include scholarships, Pell grants, employer-provided tuition assistance, and tax-free distributions from education IRAs. Table 2 summarizes the provisions for the tuition and fees deduction.

SAVINGS PROGRAMS

Taxpayers have several options for educational savings. Tax advantaged savings plans include Coverdell ESAs (education IRAs), education savings bond program, and QTPs. Special education provisions have been also added into the IRA rules. For the tax advantaged savings plans and the special education provisions added to the IRA rules, any nontaxable distribution is limited to the amount that does not exceed qualified education expenses.

Coverdell ESA

A Coverdell ESA is a trust or custodial account set up in the U.S. solely for the purpose of paying qualified education expenses for the designated beneficiary of the account. The designated beneficiary must be under the age of 18 when the account is established. The balance of an ESA must be distributed within 30 days after the date of the beneficiary's 30th birthday. In the case of special needs beneficiaries, contributions can be made beyond age 18 and distributions do not have to be made by age 30. Distributions from ESAs are free from taxation if they are used to pay for qualified education expenses at postsecondary, elementary, and secondary schools.

Funds may also be used for public, private, or religious schools. Nondeductible contributions up to \$2,000 per beneficiary are allowable from individuals as well as corporations, tax-exempt organizations, and other entities. Individual contributors are allowed to make contributions for the year up to April 15 of the following year. The contribution limit is subject to a phase out. Taxpayers may claim a Hope or Lifetime Learning credit for a tax year and exclude amounts distributed from an ESA from income on behalf of the same beneficiary as long as the distribution is not used for the same educational expenses for which the credit is claimed. Table 3 provides a summary of the provisions for Coverdell ESAs.

Qualified Tuition Program (QTP)

A QTP allows family members to either prepay, or contribute to an account established for paying, a student's qualified higher education expenses at an education institution eligible to participate in U.S. Department of Education student aid programs. Both states and eligible institutions can establish and maintain such programs. When a family uses a qualified state-sponsored tuition program to save for college, no tax is due in connection with the plan either as funds accumulate or at the time of withdrawal, as long as the distribution is less than the beneficiary's adjusted qualified higher education expenses. The same is true for institution-sponsored QTPs, except that only earnings distributed after January 1, 2004 are not taxable.

Families may use QTPs to save for tuition, required fees, books, supplies, equipment, and eligible room and board expenses. A Hope or Lifetime Learning Credit can be claimed in the same year the beneficiary receives a tax-free distribution from a QTP, as long as the same expenses are not used for both benefits. The provisions for QTPs are summarized in Table 3.

Education Savings Bond Program

United States savings bond interest may be excludable from income if used to pay for higher education expenses of a taxpayer, the taxpayer's spouse, or the taxpayer's dependents. This exclusion applies to both EE savings bonds purchased after 1989 and the newer

I-bonds that offer inflation-adjusted interest payments. Married taxpayers must file jointly. The bond owner must have bought the bond after reaching age 24 and must be sole owner or joint owner with spouse. The interest exclusion applies in the year the bond is redeemed. The exclusion phases out above certain income levels. Table 3 outlines the provisions for the education savings bond program.

	Coverdell ESA	Qualified Tuition Program (QTP)	Early IRA Distributions	Education Savings Bond Program
Applicable IRC Section	530	529	72(t)(2)(E)	135
Benefit	Earnings not taxed		No additional tax on early distribution	Interest not taxed
Annual Limit	\$2,000 contribution per beneficiary	None	Amount of qualified education expenses	
Income Phase Out	\$95,000 - \$110,000 \$190,000 - \$220,000 for joint returns	No phase out		\$63,100 - \$78,100 \$94,700 - \$124,700 for joint returns
Qualifying Expenses Besides Tuition and Required Enrollment Fees	Books, supplies, and equipment Expenses for special needs services Payments to QTP Higher education room and board if at least half-time Elem/sec (K - 12) education: tutoring, room and board, uniforms, transportation, computer access, and supplementary expenses	Books, supplies, and equipment Room and board if at least half-time Expenses for special needs services		Payments to Coverdell ESA Payments to QTP
Qualifying Education	Undergraduate and graduate K - 12	Undergraduate and graduate		
Other Conditions	Assets must be distributed at age 30 unless special needs beneficiary			Applies only to qualified EE bonds issued after 1989 or series I bonds
Source: EGTRA [2001]; IRS [2006]; TRA [1997]				

Early IRA Distributions

Early distributions from an IRA are generally subject to a 10-percent penalty tax if the taxpayer has not reached age 59½. This is in addition to any increase in regular income tax that may result from including the distribution in the taxpayer's gross income. The 10-percent penalty will not apply if the distribution is used to pay for qualified higher education expenses. The amount of qualified higher education expenses is reduced by the amounts of any qualified scholarship, education assistance allowance or payment (other than a gift or inheritance), that is excludable from gross income. The expense may be for the taxpayer, the taxpayer's spouse, or a child or grandchild of the taxpayer or the taxpayer's spouse. The provisions regarding early IRA distributions are summarized in Table 3.

CONCLUSION

With education costs increasing at all levels, taxpayers are advised to utilize the tax benefits provided by TRA '97 and EGTRA. Taxpayers should be aware that unless extended the EGTRA provides that all provisions of, and amendments made by, the 2001 Act shall not apply to taxable, plan, or limitation years beginning after 2010. In addition, the deduction for higher education expenses is currently available although it was scheduled to expire in 2005. Whether a taxpayer can take advantage of the benefits described in this article depends on the taxpayer's individual facts and circumstances. However, equipped with knowledge about the various credits, deductions, and savings programs, a taxpayer in conjunction with a financial adviser should be able to develop a plan to mitigate the impact of education expenses.

REFERENCES

Economic Growth and Tax Relief Reconciliation Act of 2001, (2001). Public Law 107-16.

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