OFF TO SCHOOL

TAX BREAKS FOR EDUCATION

Wolters Kluwer

OFF TO SCHOOL: Tax Breaks for Education

As the cost of education continues to climb year after year, a number of valuable education tax breaks can help ease the pain. Educational incentives have the ability to provide significant tax relief for individuals and families. For parents, students, working individuals, or those making plans now to save for education down the road, it is never too early – or late – to prepare for the costs of education.

The Tax Code provides some lucrative education tax breaks, and getting the most from these tax incentives requires careful planning, especially because of the overlap between many different tax rules. Nevertheless, in many instances these education tax breaks can help you maximize your overall tax savings.

This guide provides an overview of many popular, tax-smart ways of paying for education. It covers:

- Education tax credits;
- Deductions for higher education expenses;
- Student loan interest deduction;
- Coverdell education savings accounts;
- 529 plans;
- Scholarships;

- Employer educational assistance;
- Business expense deduction;
- Tax-exempt bonds; and
- *Uniform Gift To Minors Act* brokerage accounts.

EDUCATION TAX CREDITS

Two tax credits are currently available to be used to lessen the cost of education after high school. These credits, the Lifetime Learning Credit and the American Opportunity Tax Credit (AOTC), can help with the costs of tuition and fees of post-secondary education.

American Opportunity Tax Credit

The AOTC is a taxpayer friendly modification of the HOPE education credit, which generally allowed eligible taxpayers to claim a nonrefundable credit against federal income taxes for tuition and related expenses for only the first two years of post-secondary education for *each* eligible student. The AOTC modified and enhanced the HOPE credit by increasing the credit amount, having it apply to all four years of post-secondary education, increasing the income phaseout ranges, expansion of qualifying expenses, and making a portion potentially refundable.

Through 2017, to qualify for the AOTC, tuition must be paid on behalf of the taxpayer, the taxpayer's spouse, or dependent. The maximum credit amount available is $2,500 per year *for all four years of college*. The credit is equal to 100 percent of the first $2,000 in qualifying higher education expenses, plus 25 percent of the next $2,000 of eligible expenses. Eligible expenses include costs relating to text books and course materials.

The AOTC, as noted, is 40 percent refundable. However, if the taxpayer claiming the credit is a child who has at least one living parent, does not file a joint return, has unearned income subject to the "kiddie tax," and meets certain other criteria; none of the credit is refundable.

> ***Caution.*** Absent further legislation, the AOTC is scheduled to revert to the HOPE credit rules after 2017.

Eligible students

To be eligible for claiming the AOTC, a student must be enrolled at least half-time (i.e., carrying at least one half of the full-time academic course load) for at least one academic period during the year, in a degree, certificate or other program leading to a recognized educational credential at an eligible educational institution. In addition, the student *must* not have any federal or state felony drug convictions.

Qualifying educational institutions

An eligible educational institution includes most types of accredited post-secondary institutions that offer credit towards a bachelor's degree, associate's degree, or other recognized post-secondary credential. Proprietary institutions and vocational schools may also qualify. Graduate school degrees are *not* covered.

Qualifying expenses

Qualifying expenses generally include tuition, required enrollment fees, and course materials such as books, supplies, and equipment needed for a course of study. Course materials do *not* need to be purchased from the educational institution as a condition of enrollment in order to qualify.

> ***Caution.*** Non-qualifying expenses include but are not limited to: (1) room and board; (2) transportation; (3) student fees not required as a condition of enrollment; (4) medical expenses including student health fees; or (5) any expenses already covered by a tax credit or deduction.

Income phaseout

The phaseout range of the AOTC through 2017 for married couples filing jointly is a modified adjusted gross income (MAGI) between $160,000 and $180,000. The credit phases out for single individuals with MAGI between $80,000 and $90,000.

> **Caution.** The AOTC is *not* available to married couples who file separate returns.

The AOTC is ratably reduced by the amount bearing the same ratio to the credit as to the excess of the taxpayer's MAGI over $80,000 (or $160,000 for joint returns) bears to $10,000 (or $20,000 for joint returns). MAGI is a taxpayer's adjusted gross income increased by any amount excluded from gross income attributed to foreign earned income or the foreign housing exclusion. While this may sound complicated, an example may help.

> **Example.** Thomas is a full-time student in 2014 at a college with tuition and related expenses of $10,000. Thomas' widowed mother, Roberta, pays for his tuition at the college and wants to claim the AOTC on Thomas' behalf. Roberta's MAGI for 2014 is $82,000. The ratio of the excess of Roberta's MAGI, $2,000 ($82,000 - $80,000) over $10,000 is 1/5 ($2,000/$10,000 = 1/5). The maximum AOTC available ($2,500) to Roberta is therefore reduced by 1/5, so she can only claim a $2,000 credit ($2,500 - (1/5 x $2,500) = $2,000).

LIFETIME LEARNING CREDIT

The Lifetime Learning credit is equal to 20 percent of up to $10,000 of qualified tuition and related expenses. The expenses must be paid by the taxpayer during the tax year for education furnished to the taxpayer, the taxpayer's spouse or dependent(s) during any academic period beginning in the tax year. Thus, the maximum credit amount *per taxpayer return* is $2,000. These amounts are not indexed for inflation. For purposes of calculating the Lifetime Learning credit for any given year, the determining factor is when the tuition was paid, not when the classes took place.

> **Example.** A married couple prepaid their daughter's tuition in the fall of 2013 for classes to be held in the 2014 spring semester. The tuition is used to calculate the Lifetime Learning credit for the year when the tuition payments were actually made (2013), which is the year prior to the year she actually attended classes (2014).

Per-taxpayer credit

Unlike the AOTC, the Lifetime Learning Credit is a *per-taxpayer* credit, and does not change based on the number of qualifying students. The Lifetime Learning credit and the AOTC cannot be taken for the same tax year for the same student. In effect, they are "either/or" credits because expenses claimed with regard to the AOTC cannot also be taken into account for purposes of the Lifetime Learning credit.

Qualifying students and schools

The Lifetime Learning credit is available for an unlimited number of tax years, as well as for a wider range of education expenses. The credit can be claimed for expenses incurred to pay for undergraduate, graduate, and professional degree courses, including expenses for courses of instruction at an eligible educational institution to acquire or improve job skills, even if it is *not* part of a degree program or the student is not enrolled on at least a half-time basis. The Lifetime Learning credit is thus allowed for a student who has just graduated from high school and is taking a single course at a community college.

Income phaseout

The Lifetime Learning credit also phases out as a taxpayer's modified adjusted gross income (MAGI) rises. For 2013, the credit begins to phaseout for joint filers with MAGI over $107,000 ($53,000 for single filers). For 2014, the credit begins to phaseout for joint filers with a MAGI over $108,000 ($54,000 for single filers).

TUITION AND FEES EXPENSE DEDUCTION

The above-the-line tuition and fees expense deduction for higher education has been a popular but temporary tax break for qualified tuition and related expenses that has been extended year after year by Congress.

> ***Caution.*** Absent further legislation, the above-the-line tuition and fees expense deduction expired on December 31, 2013.

Qualifying expenses

The tuition and fees expense deduction could be claimed for tuition and academic fees only; expenses for the cost of books or room and board could *not* be included. Additionally, the amount of expenses you could claim had to be reduced by distributions excluded from income from a state tuition plan (for example, a "529 plan" or "qualified tuition program (QTP)," discussed in further detail later), an education savings account, or interest on certain U.S. saving bonds used to pay educational expenses. If tuition fees were too low to claim the full amount, taxpayers can claim tuition for the first three months of the following year, but only if paid during the tax year in which the deduction is being claimed.

Eligible individuals

You could claim the deduction for your education expenses, your spouse's, or your dependent's. Neither your dependent nor married taxpayers filing separately can claim the deduction.

> ***Caution.*** You cannot claim both the tuition and fees expense deduction and either of the education tax credits (AOTC or Lifetime Learning credit). These education incentives were "either/or" tax breaks.

The maximum amount of the higher education deduction was two-tiered based on the level of your modified adjusted gross income (MAGI). For example, if you were single or head of household in 2013, you could claim a deduction of $4,000 if you're MAGI, exclusive of the tuition and fees expense deduction, does not exceed $65,000, and a deduction of $2,000 if your MAGI does not exceed $80,000. Above $80,000, the deduction is eliminated. For joint returns, the AGI limits were doubled: $130,000 for a $4,000 credit; $160,000 for a $2,000 credit.

CREDITS OR DEDUCTIONS—WHICH IS BEST?

You cannot "double-dip" when it comes to claiming education tax breaks. For example, if you receive a tax-free scholarship, you cannot claim

those same expenses covered by the scholarship as expenses eligible for a tax credit or a deduction.

Another important factor is your tax bracket is determining whether to take a deduction or claim a credit.

If you are paying for an education expense out-of-pocket, 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.

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 reduces your overall tax liability dollar for dollar. For most people, a credit is more beneficial than taking a deduction – but only if the same amount of expense would qualify as an either/or choice. Usually, you will 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 x 25 percent) 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. Alternatively, if you are in the 15 percent tax bracket, you would only save $150 ($1,000 x 15 percent) by taking the deduction so you would be better off claiming the $250 credit.

STUDENT LOAN INTEREST DEDUCTION

If you borrowed money to pay for school, you can take an above-the-line deduction for up to $2,500 a year for the interest you paid on education loans. As an above-the-line deduction, it is not limited to taxpayers who claim itemized deductions.

What loans qualify?

Any debt incurred to pay higher education expenses for:

- 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 his or her college expenses, only your child can deduct interest on the loan, even if you pay the interest.

Income phaseout

Not everyone can take the student loan interest deduction. Eligibility depends on your income. For 2013, the maximum $2,500 deduction for student loan interest phases out for single individuals with MAGI between $60,000 and $75,000, and for joint filers with modified AGI between $125,000 and $155,000. For 2014, the maximum $2,500 deduction for student loan interest phases out for single individuals with MAGI between $65,000 and $80,000, and for joint filers with modified AGI between $130,000 and $160,000.

Interaction with other benefits

You may claim the AOTC or the Lifetime Learning credit for expenses paid for with a student loan. In determining if the student loan was used for qualifying higher education expenses, you must subtract from your total qualifying expenses any U.S. savings bond interest deducted under the Education Savings Bond program, any withdrawals from a Coverdell Education Savings Account (Coverdell ESA), and distributions from a qualified tuition program (QTP or 529 plan) used to pay higher education expenses and excluded from your taxable income.

QUALIFIED TUITION PLANS

Qualified Tuition Plans (QTPs), also known as "529 plans," are popular tax-favored education savings vehicles. A QTP is a plan that is established to allow you to either prepay, or contribute to, an account established solely for paying a student's qualified education expenses at an eligible educational institution. Once limited to state programs, QTPs have been expanded to include prepaid tuition programs established and maintained by eligible private institutions that satisfy certain requirements.

As a result, there are actually two types of QTPs: savings account programs and prepaid tuition programs. However, you cannot make contributions to both. Each type of program is discussed in further detail below.

> ***Comment.*** The economic downturn took a toll on many 529 plans, as parents' ability to put money away for college takes a back seat in many households to paying day-to-day expenses. However, a small contribution can go a long way in the long-term. Many plans are offering a wider range of investment options and lowering various fees to attract participants.

Qualified tuition programs

One 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.

Savings account plan

The other 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.

Plan Contributions

Contributions to QTPs are not deductible, however, for the beneficiary, the QTP itself is generally exempt from tax. Contributions made to a 529 plan must be in cash. These contributions are generally treated as completed gifts for purposes of the annual gift tax exclusion. For example, for 2013 or 2014, a $70,000 lump sum contribution can be treated as if made over a five-year period using the annual gift tax exclusion amount of $14,000.

Distributions and rollovers

Distributions that are used to pay the beneficiary's qualified education expenses are tax-free. Other, nonqualified distributions are included in the beneficiary's income, and are subject to a 10-percent penalty. Rollovers from one QTP to another are tax-free if made for the benefit of the same beneficiary or for related beneficiaries. A QTP can also be transferred tax-free to a member of the beneficiary's family.

No income phaseout

Many more people can take advantage of 529 plans because there is no income phaseout, unlike other education tax incentives.

COVERDELL EDUCATION SAVINGS ACCOUNTS

Coverdell Education Savings Accounts (Coverdell ESAs or ESAs) are another way to save and pay for education. To get real tax savings, you generally need 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 ESAs are very taxpayer-friendly. The account balance is never taxed, not even to the student, when it is used for qualified education expenses. You can contribute up to a maximum of $2,000 to a Coverdell ESA. Contributions are not tax deductible, however, and must be made in cash. Amounts not used to pay for qualified education expenses are considered income to the individual who receives the distribution from the account, and are subject to income tax, as well as a 10 percent penalty.

> **Comment.** A Coverdell ESA can only be established for a qualified beneficiary under the age of 18, or a special needs beneficiary.

Educational institutions

Coverdell ESAs can be used not only to pay for college costs but also for elementary and secondary school education expenses. The student can attend a public, private or religious school.

Eligible expenses

Eligible expenses include, among other things, tuition, fees, books, and supplies. They also include room and board for a student enrolled at least half-time.

Income phaseout

Coverdell ESAs have the following income phaseout ranges:

- The contribution limit is phased out for married couples filing jointly with modified adjusted gross incomes (MAGI) from $190,000 to $220,000.
- The MAGI phaseout range for single individuals is $95,000 to $110,000.

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 pursuing a degree, you will be considered a student pursuing a degree if you receive a scholarship to study at an educational institution that:

- Provides a program that is acceptable for full credit toward a bachelor's degree or a higher degree, or offers a program to prepare students for gainful employment in a recognized occupation;
- Is government authorized; and
- Is nationally 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 excludable from your income. Room and board isn't excluded.

EMPLOYER-PROVIDED EDUCATIONAL ASSISTANCE

If your employer helps with education expenses, you may be able to exclude from your gross income up to $5,250 in employer provided educational assistance. Courses covered by your employer's program don't always have to relate to your job or be a part of a degree program. If they are related, you may also deduct any costs not reimbursed as a business expense deduction, provided you satisfy certain requirements and itemize your deductions.

BUSINESS DEDUCTION FOR WORK-RELATED EDUCATION COSTS

If the tuition and fees incurred by a student-employee are not deductible under the tuition and fees expense deduction, they may be deductible as ordinary and necessary business expenses. Unlike the tuition and fees expense deduction, however, job retraining to qualify you for another line of work is *not* covered as a business expense deduction. Tuition, training, and similar costs associated with entering a new line of work are *not* deductible. Similarly, education costs to obtain a professional license are generally *not* a deductible business expense.

Continuing education

Education costs incurred to improve the employee-student's skills or to satisfy continuing education requirements may be deductible as an itemized miscellaneous deduction subject to the two-percent-of-adjusted-gross-income floor. These costs include continuing education courses or advanced degree costs for a field that the individual has already entered. Deductible costs also include education costs undertaken to meet the express requirements of the employer, or of a law or regulation imposed as a condition to retain employment, status or rate of compensation.

Seminars and conferences

Costs associated with attending seminars, conferences, conventions, and similar education courses are subject to strict substantiation requirements if you otherwise qualify to take them as a business expense. If the meeting or conference is conducted in certain countries or locations, the substantiation requirements are even stricter. These costs are also deducted as miscellaneous itemized deduction subject to the two percent–of-adjusted-gross-income floor.

Reimbursed expenses

If the student-employee's education expenses are reimbursed by the employer, the amount of the reimbursement can be excluded from the employee's income. If these costs are not reimbursed, they are treated as deductible unreimbursed employee business expenses.

If the costs are not reimbursed by the employer, a deduction may be available as the cost of producing income. The deduction can be claimed on Form 1040, Schedule C, by self-employed persons. Employees may claim the deduction for unreimbursed education expenses only if they itemize deductions on Schedule A. The deduction is subject to the two-percent-of-adjusted-gross-income floor that applies to most miscellaneous itemized deductions.

SAVINGS BONDS

U.S. 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 are backed by the U.S. government. Qualified U.S. savings bonds are either series EE bonds issued after 1989 or series I bonds. However, the bonds must not be purchased in the child's name or held in the child' name. One requirement for exclusion of the interest income is that the owner must be at least 24 years old on the bond issuance date.

Caution. When savings bonds are redeemed to pay expenses for higher education, although the interest may be excluded from your income when used to pay qualifying education expenses, the amount excludable declines as your income rises. For 2013, the MAGI phaseout range for joint filers is $112,050 to $142,050 ($74,700 to $89,700 for single filers). For 2014, the MAGI phaseout range for joint filers is $113,950 to $143,950 ($76,000 to $91,000 for single filers). Finally, you cannot exclude interest on qualified

U.S. saving bonds used to pay for qualified education expenses if your filing status is married filing separate.

Higher educational expenses for tax purposes are tuition and fees required for enrollment or attendance of you, your spouse or your dependent(s) 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 (QTP) 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 $14,000 tax-free ($28,000 if you and your spouse "split" each gift) in 2013 and 2014. You can contribute enough just to cover tuition. However, once your child turns the requisite age (from 18 to 24, depending upon circumstances), he or she can take the money and use it for anything, not just education. This is a concern of many parents considering a UGMA.

The success of a UGMA depends on how you invest the money. Since investment earnings of a child under the kiddie tax are taxed at his or her parents' marginal rate, the account must have as little taxable earnings as possible until he or she is out of kiddie tax range.

The kiddie tax applies to children who are under age 18, or, if the child's earned income does not exceed half of the child's own support for the year, either 19 or, if a full-time student, under 24. In any case, the child is out of the grasp of the kiddie tax for the entire tax year in which he or she turns the requisite 18, 19 or 24 years of age.

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 24 (or 18 or 19, as the case may be), at which time the stock would be sold slowly over the course of the next three to four years, at the child's presumably 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 24 while in graduate school full time, you can have the shares sold for her gradually over the next three or four years and she will be taxed on the $64,000 gain, which usually will be at a lower capital gains rate than your bracket, especially if she continues full-time toward a graduate degree.

WITHDRAWING FROM RETIREMENT SAVINGS

Don't withdraw money from a retirement savings plan unless you're using it for retirement, since the amounts distributed are generally taxable as income and subject to a 10 percent early withdrawal penalty as well. There are, however, some very limited exceptions that may be used if absolutely needed to help pay educational expenses.

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. Remember, however, that once you take the money out of your tax-favored retirement account you can't put it back and, therefore, you permanently lose the benefit of having that amount continue to accrue tax-free before it's needed.

Not tax-free

To take money out of an Individual Retirement Account (IRA), you need to 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 if you meet all the requirements to qualify for an educational expense exception withdrawal.

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 tax breaks 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 extent.