

Tax Breaks for College

We don't need to tell you that college costs are skyrocketing. However, Washington has eased the pain a bit over the past several years by offering up some attractive tax breaks to those trying to pay the college bills.

Sadly, many parents are missing these breaks and hence the opportunity to save. The U.S. Government Accountability Office reported in 2006 that 27% of eligible tax filers missed deductions and credits intended to help defray the cost of college.

The information below will hopefully help prevent such oversights, but be sure to initiate this conversation with your tax preparer as well. In other words, at tax time, ask a qualified tax preparer about credits and deductions for your child's college education. It is his/her job to stay on top of these deductions as they will inevitably change over time. And they're tricky – sometimes using one break precludes the use of another. There are also income thresholds that disqualify some people, and these change frequently. We have included them here as of this printing but you will need to check the thresholds at the time you pursue these breaks.

At least for now, these tax breaks can mean hundreds or even thousands of dollars in savings to qualified families.

Two Major Types of Breaks

1) **Tax deductions** – reduces taxable income; income thresholds are generally higher so these are available to more people;

2) **Tax credits** – usually the most desirable since they are dollar for dollar reductions in taxes paid;

Deductions

The Tuition and Fees Deduction

This is an "above the line" deduction that allows parents to deduct 100% of the cost of tuition and fees (tuition, books, equipment and supplies) up to a max of \$4000 (as of 2007) per year. "Above the line" means that you don't have to itemize in order to claim it. The max applies regardless of how many children you have in school. This deduction reduces taxable income so can help parents qualify for other deductions and credits as well. Parents earning up to \$65,000 if single and \$130,000 if married can obtain the maximum deduction. Smaller deductions (up to \$2000) are available for corresponding income limits of \$80,000 (single) and \$160,000 (married). This is no longer a line on the 1040 form (as of this printing) but qualifiers should write it in on line 35. Note that this deduction expired in 2005 but is extended on a year to year basis.

Here are some other restrictions:

- You don't qualify if you're married but file separately from your spouse;
- No deduction is allowed on a return of a person claimed as a dependent on another's return;
- No deduction can be claimed for expenses that were paid using earnings from a section 529 plan or withdrawals from a Coverdell ESA.
- You can't claim this deduction in the same year that you take a Hope or Lifetime Learning tax credit; (see below)

Credits

Hope Scholarship Credit

A parent may claim a tax credit for 100% of the first \$1,100 and 50% of the next \$1,100 of a dependent child's tuition and mandatory fees, for a maximum \$1,650 tax credit per child. (The maximum is \$3,300 for a Gulf Opportunity Zone* student.) Students may claim this credit if they are not claimed as a dependent on another person's tax return. The full credit is available for singles with incomes up to \$45,000, and lesser credit amounts apply up to \$55,000. (\$90,000 and \$110,000 for married filing jointly) If your income exceeds \$55,000 (single) or \$110,000 (married), the credit does not apply at all. Further, this credit is only applicable for students are attending a degree program at least half time and who have not completed their first two years (freshman and sophomores) of academic study before the beginning of the taxable year. At least one qualifying academic period must begin during the tax year to which the credit is being applied. In addition, the student cannot have had a drug felony conviction in a year in which the credit applies. If cannot be claimed in more than two years for any one student.

**Note: The Gulf Opportunity Zone Act was signed by President Bush in 2005 to aid citizens of the Gulf Coast.*

Lifetime Learning Credit

A taxpayer may claim a tax credit of 20% of up to \$10,000 in combined tuition and mandatory fees for himself, his spouse and his dependent children. To compute eligible education expenses, you must deduct scholarships, grants and other tax-free tuition benefits. The maximum benefit is \$2000 per tax year and \$4000 for a Gulf Opportunity (GO) Zone student. This credit has the same income thresholds as the Hope Credit. If you claim a Hope Scholarship Credit (above), you may not claim a Lifetime Learning Credit for any of the student's expenses in the same tax year. However, there is no requirement for the student to be pursuing a degree or to be enrolled half time or more. There is also no limit on the number of years the credit may be taken.

Which is the Best?

Prevailing wisdom would generally hold that you should go for credits first (vs. deductions). Then, the Hope vs. Lifetime decision will depend on the amount of qualified expenses. The Hope Credit may be better for those with bills of less than \$8,250 whereas the Lifetime Learning Credit will probably be better if you spend more than that on tuition and fees.

Also, if you have multiple children in college there may be some additional strategies you can use. Your tax preparer can help you with this.

Other College Tax Breaks

Qualified Tuition Programs (Section 529 plans)

These plans come in two basic forms: **college-savings plans** (which allow people to invest after-tax dollars in a basket of mutual funds, with the assets growing tax free until those college bills start rolling in) and **prepaid tuition plans** (which allow people to lock in today's tuition prices for set schools, most often public schools in their home state).

In recent years, college-savings plans have been considerably more popular than prepaid tuition plans. The reasons for the difference are many. For starters, college-savings plans are easier to understand — they operate a bit like 401(k)s, with the notable exception that withdrawals are taken to cover college. College-savings plans can also be used to cover a

wider range of college costs, like books and supplies, whereas most prepaid plans only cover the cost of tuition and fees.

And finally, there was a significant financial-aid issue: In the past, college-savings plans were treated more favorably under the federal financial-aid rules than prepaid tuition plans. Benefits paid out of prepaid plans were considered a resource of the child to pay for college. So withdrawals from a prepaid plan reduced federal financial-aid eligibility dollar for dollar. College-savings plans, on the other hand, are viewed as an asset of the account owner (most often, the parent), which means that, when it comes to determining financial aid, no more than 5.6% of the account value is considered available to pay the bills.

Recently, however, this financial-aid issue has been resolved. Thanks to the *Pension Protection Act*, a new law that went into effect in August 2006, federal financial-aid formulas now treat prepaid plans in the same manner as college-savings plans. In other words, distributions from both types of accounts are viewed as a parental asset. This is good news, as that no longer needs to influence your choices.

State-Sponsored College Savings 529 Plans

These are plans whose earnings grow tax-deferred and distributions are tax-free if used for qualified post-secondary education costs. These programs are sponsored by states, but most are open to people in and out of the state. In most states, the withdrawals are also state-tax-free. Some states also offer in-state residents a state-tax deduction or a credit on contributions. These plans, while not perfect, do offer some great advantages. www.savingforcollege.com offers some convenient comparisons of the different states' offerings.

Here's the basic deal. You contribute money to one of these plans, which is then invested in some sort of savings vehicle — typically mutual funds. Many of these plans offer stock funds when a child is quite young, which will then be transferred to more conservative investments, like bond funds, as the child gets closer to college age. Of course, unlike the prepaid tuition plans, there are no guarantees that your money will grow large enough to cover your tuition bills. But if you invest in a good plan, the returns (combined with the tax-free withdrawals) certainly give you a leg up. Also, these plans aren't strictly geared toward in-state schools, but are meant to be applied toward whichever school your child chooses to attend.

Withdrawals to pay the beneficiary's qualified college expenses are tax-free. If you can make substantial contributions to a 529 plan while your child is young, this can make a huge dent in the amount you will ultimately need for his/her education. You can usually make large lump-sum contributions (well over \$250,000) and for gift-tax purposes you can spread a large gift over 5 years. (Gifts under \$12,000 made under the tax-free gift rule won't result in federal gift taxes and won't reduce your federal gift or estate tax exemptions.) When contributing to a 529 plan, you can claim 5 years worth of \$12,000 exclusions up front, which means a married couple can make a lump-sum payment of up to \$120,000 (5 x \$12,000 x 2 parents) without any negative gift tax consequences. And another plus: These tax benefits are available regardless of how high your income is as opposed to many of the other breaks. You can change your beneficiary easily, too, but you still pay tax and an IRS penalty (10%) if you withdraw your funds for something other than college-related expenses. The penalty may be waived if the account beneficiary (the college bound child) receives a scholarship, becomes disabled or dies.

Another thing to keep in mind is that investing in a college-savings plan could also affect your financial-aid eligibility. College-savings plans are typically viewed as a parental asset,

rather than a child's. (that's good news) And that means that a financial-aid officer would count a maximum of 5.6% of those assets toward your financial-aid eligibility. That's not a huge negative and, no matter what, don't let the fear of hurting your child's eligibility for financial aid paralyze you from developing a sound savings strategy.

Section 529 Prepaid College Tuition Plans

Don't confuse these with the 529 plans discussed in the previous paragraph. Both are allowed under Section 529 of the Tax Code, but prepaid tuition plans lock in the cost to attend certain in-state colleges. The basic premise of a prepaid plan is this: You can pay now for future college costs and by doing so lock in today's rates (or close to it — you may pay a slight premium). Considering that tuition and fees for public four-year colleges increased an average of 7.2% annually from 1990 through 2006, according to the College Board, this is a good deal. Withdrawals from these plans are federal-tax-free and, in most states, state-tax-free as well. The same basic withdrawal restrictions and penalties as the 529 savings plans.

Prepaid-tuition plans come in two forms. Until recently, prepaid plans were only offered by specific states and the plans centered on the major public universities in that state. In the fall of 2003, however, a private-school prepaid-tuition plan was introduced. This plan, known as the Independent 529 Plan, allows families in any state to pay today's tuition prices for future tuition bills at more than 257 participating private colleges.

Both types of prepaid plans come with some major drawbacks. First off, these plans obviously substantially restrict school selection. Granted, refunds are available, but if your child is attending a school not covered by the plan, there are no guarantees that the amount you have set aside in your prepaid plan will cover the school's costs. In many cases, it won't even come close.

Prepaid plans are tied to a specific group of schools, not the national average. In most cases, they're tied to in-state public schools. Of the 13 state-school-oriented prepaid plans currently open for enrollment, only two — Alabama and Massachusetts — allow nonresidents to invest. (as of this printing)

This, of course, begs the question of what happens when your child decides to head to a school *not* included in your prepaid plan. Folks who contributed to the Independent 529 plan, which currently has over \$100 million under management, are out of luck: *The plan will not pay tuition at any nonparticipating school.* Instead, account owners can roll over their money to other beneficiaries or to a 529 college-savings plan. Refunds are also allowed, and you will not incur taxes on the earnings and a 10% penalty if the money is used to pay for school. However, the account owner only gets back the principal plus or minus the portfolio's annual rate of return, which is capped at 2%. That's not a good deal. Right now, you could earn a higher return by investing your money in a high-yield savings account.

With the state-school plans, however, the results aren't as restrictive. Assets can be used to pay for any college, including in-state private schools and out-of-state public and private schools. However, if you bought into your state's prepaid plan, but your child was accepted to Harvard, your plan will pay you based on the average public college tuition for the year.

For parents who are wary of investment risk, the appeal of a prepaid plan's guaranteed return is obvious. In fact, if tuition rates continue going up at the current pace, parents may end up better off in prepaid plans than in college-savings plans. But because of high tuition inflation, many prepaid plans are having trouble proving they can meet their future obligations. Currently, five states — Colorado, Kentucky, Ohio, Texas and West Virginia — have closed their prepaid plans to new enrollment because of "unfunded liability," which basically means the plan's assets are less than its future liabilities.

Should parents be worried? As of this printing, no program has defaulted on current obligations. When looking at unfunded liabilities, they are typically 15 to 20 years in the future. There is still time for these plans to make up the gap or for the state to step in. Many prepaid plans do, in fact, carry some form of state guarantee, and probably at least half have unfunded future liabilities. So for the very wary, this is something to ponder.

Coverdell Education Savings Accounts (ESAs or CESAs)

These used to be called Education IRAs. The account's earnings grow tax-deferred and distributions are tax-free when used for qualified post-secondary education costs. These may also be withdrawn tax free for primary and secondary school expenses. The beneficiary must be under the age of 18 when a CESA contribution is made. You may not report the same educational expenses from a 529 plan and an ESA, nor do expenses covered by a Hope or Lifetime credit apply. There is also an annual contribution limit of \$2000 (not deductible) which is reduced if the contributor's income is between \$95,000 and \$110,000 (single) and \$190,000 and \$220,000 (married). You must make your contribution for the tax year by April 15 of the following year, for example, by April 15, 2008 for the 2007 tax year. Children can make contributions to their own account. These accounts make the most sense for parents who want maximum control over their investment options and who are unlikely to want to contribute more than \$2000.

Student Loan Interest

Interest on student loans is tax deductible up to a maximum amount of \$2,500 annually, but is reduced when single income exceeds \$50,000 and joint income exceeds \$105,000. The deduction disappears for single income over \$65,000 and joint income over \$135,000. This amount may be deducted "above the line" (meaning you don't have to itemize) as long as the debt was incurred in order to pay college costs for yourself, your spouse or your dependent while enrolled at least half time in a degree program. A student may not take this deduction if they are claimed as a dependent on another's tax return. However, if a parent repays a student's (or former student's) loans, the repayment is considered to be a gift to the child. As such, the child can take the interest deductions on his/her return.

US Savings Bonds

EE and I bonds that were purchased after 1989 by someone age 24 or older may be redeemed tax-free when the owner or the owner's spouse or dependent pays for college tuition and fees. As of 2006, the tax exclusion phases out for incomes between \$63,100 and \$78,100 (between \$94,700 and \$124,700 for married taxpayers filing jointly). These income limits are generally increased each year.

Individual Retirement Accounts (IRAs)

When Roth IRAs and traditional IRAs are used to pay for qualified post-secondary education for yourself, your spouse, your children or your grandchildren, the early withdrawal penalties (10%) are waived.

Tax-Free Scholarships

Most grants and scholarships are tax free if the recipient does not have to provide any services in exchange for the reward. They must be paying for qualified expenses for degree candidates at eligible schools.

Tax-Free Educational Assistance

Employers may pay and deduct up to \$5,250 per year in college and graduate school costs for each employee under a section 127 educational assistance plan. The education does not have to be job related, and the benefit is tax-free to the employee. However, the benefit may not be used to pay for an employee's family members' education.

Information is Vital

The options explained in this manual are obviously quite extensive and often confusing. Many families will want to contact financial professionals to be sure they are interpreting the options correctly and making the best choices.

There is additional information about tax incentives for education found on the IRS website, www.irs.gov, IRS Publication 970 "Tax Benefits for Higher Education". www.irs.gov/pub/irs-pdf/p970.pdf or call 800-829-1040. Publication 520, Scholarships and Fellowships, may also be helpful. You can also call 1-800-TAX-FORM.

Meanwhile, be sure to save all records of education-related expenses and all financial aid records as well. Your student's college or university will collect his or her social security number so that they can issue reports that assist you in preparing your taxes. All institutions are required to provide a form 1098-T (Tuition Payments Statement) to students from whom or for whom they receive payments.* Banks and other lending institutions to whom student loan interest is paid will also provide a form 1098-E (Student Loan Interest Payments) if more than \$600 was collected during the tax year. These records are not generally submitted when applying for credits or deductions, but they are very useful in helping you determine your qualified expenses.

Finally, here is a summary of which education level qualifies for which tax break:

The Tax Break	Eligible Education
Hope Credit	first two years of undergraduate
Lifetime Learning Credit	undergraduate, graduate, and job-related classes
Education Deduction	undergraduate, graduate, and individual classes
Student Loan Interest Deduction	undergraduate, graduate
Section 529 Plan Distributions	undergraduate, graduate
Education Savings Accounts	K-12, undergraduate, graduate
Employer Provided Tuition	undergraduate, graduate

Note: The financial information in this manual is of a general nature and may not apply to all situations. Contact a financial and/or tax advisor before making significant decisions.