



EDUCATION TAX BREAKS

There are many tax breaks for educational expenses that can provide hundreds and sometimes thousands of dollars of tax reduction off the total tax bill of families, not only for the children in college or graduate school, but also for parents to pursue further education and training. The various tax breaks, most recently expanded by the 2010 Tax Relief Act, often require coordination to maximize.

Many of these education tax breaks are complicated. Maximizing the benefits from these deductions, credits, and exclusions and opportunities for tax-free savings often requires careful planning, particularly because of the interrelationship between many of the rules. Although the Internal Revenue Service has provided additional guidance during the past several years to help taxpayers comply with many of the rules, some of the IRS procedures have actually complicated matters in some circumstances.

The primary tax breaks carved out for education include the following:

Education tax credits. These consist of two separate credits: the American Opportunity tax credit of up to \$2,500 per year per student for tuition, fees, books, supplies and equipment for each of the first four years of undergraduate school, and the Lifetime Learning credit that is worth up to \$2,000 per year for an unlimited number of years for college undergraduates, graduate students or working Americans pursuing job skill training. The benefits of the Lifetime Learning credit begin to "phase out" for couples with more than \$102,000 (\$51,000 for single filers) of adjusted gross income (AGI). The "phase out" is higher for the American Opportunity tax credit beginning at \$160,000 for joint filers and \$80,000 for single filers. In addition, the American Opportunity tax credit is 40% refundable up to \$1,000 whereas the Lifetime Learning credit is non-refundable. The credits apply to qualified tuition and related expenses of the taxpayer, the taxpayer's spouse, or any dependent of the taxpayer for whom a personal exemption can be claimed.

Tuition and Fees deduction. An above-the-line deduction is available for certain higher education expenses - regardless of whether the education is related to the taxpayer's trade or business or employment. Generally, the deduction is available for tuition, fees, books, supplies & equipment required for enrollment or attendance of an eligible student at a post-secondary educational institution. The deduction is allowed for the qualifying expenses of the taxpayer, the taxpayer's spouse, or any dependent of the taxpayer for whom a personal exemption can be claimed.

The maximum deduction is \$4,000, available to taxpayer's with AGI of up to \$65,000 for single filers and \$130,000 for joint filers. A reduced deduction of \$2,000 is available to single filers with AGI up to \$80,000 and to \$160,000 for married filers. The deduction can't be claimed for an individual's expenses if, during the same year, the American Opportunity tax credit or Lifetime Learning credit is claimed for that individual.

Qualified Tuition Program (QTP). A person can make nondeductible cash contributions to a qualified tuition program (QTP, or 529 plan) on behalf of a designated beneficiary. The earnings on the contributions build up tax-free and distributions from a QTP are excludable to the extent used to pay for qualified higher education expenses. Non-qualifying distributions are subject to penalties but there are exceptions to these rules.

A QTP is a tax-exempt program established and maintained by a state (including a state agency or instrumentality), or one or more eligible educational institutions (including private ones) under which a taxpayer may:

- buy tuition credits or certificates on behalf of a designated beneficiary which entitle the beneficiary to a waiver or payment of qualified higher education expenses - i.e., a prepaid educational services account such as the Washington State GET program, or
- make contributions to an account set up to meet the designated beneficiary's qualified higher education expenses - i.e., an educational savings account.

Education Savings Accounts (ESA). Formerly known as Education IRA's, the maximum annual contribution to an ESA is \$2,000. The limit applies per beneficiary, rather than per contributor. Parents can maximize benefits, however, by transferring older siblings' accounts for use by a younger brother, sister or first cousin, thereby maximizing the tax-free growth period. The phase-out amounts of adjusted gross income allowed for a contributor to an ESA begins at \$190,000 for joint filers and \$95,000 for single filers.

Amounts in an ESA may also be used for K-12 tuition and related expenses, as well as for higher education expenses. However, if a student is college bound, it nevertheless usually will make more sense to retain amounts in the ESA until college so earnings can continue to be compounded tax-free for the longest period of time permitted. Although the contributions aren't deductible, funds in the account aren't taxed, and the distributions are tax free if spent on qualified education expenses.

Employer-provided Educational Assistance. IRC Sec. 127 provides that employer-provided educational assistance is excludable from an employee's income if paid pursuant to an education assistance program offered to all employees. The exclusion for each employee is limited to \$5,250 per calendar year and applies even if the education is not job-related. The exclusion applied for both undergraduate and graduate education.

Student Loan Interest Deduction. Student loan interest of up to \$2,500 a year is deductible each year whether or not a taxpayer itemizes deductions. The deduction begins to "phase out" based on AGI of \$120,000 (\$60,000 for single filers).

Savings Bond Interest Exclusion. Series EE U.S. savings bonds offer two tax-savings opportunities when used to finance your college expenses. First, you don't have to report the interest on the bonds for federal income tax purposes until the bonds are cashed in and second, the interest may be exempt if the bond proceeds are used for "qualified higher education costs" for any individual who is your dependent (or for you or your spouse). For married taxpayers, the phase-out of benefits starts at \$106,650 of AGI (\$71,100 for single filers).

IRA Withdrawals. The 10% penalty tax on early withdrawals does not apply to a distribution from an IRA if the taxpayer uses the money to pay qualified education expenses at an eligible educational institution as well as room and board if the student is enrolled at least half time. Expenses for graduate-level courses also qualify for the penalty waiver. However, the distributions are subject to tax under the normal rules and may not be the best way to finance education costs.

The above list is not comprehensive but will hopefully give you some insight into the many tax incentives available to offset the costs of higher education. Not all of the above breaks can be used in the same year and use of some of them reduces the amounts eligible for other breaks. Additionally, depending on the income level of the parents, it may be beneficial to shift the education incentives to the child. Planning ahead and looking at the various scenarios can help to maximize the tax savings for the family.