Education Tax Benefits for Students for the 2004 Tax Year

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Introduction

Many people continue their education after graduating from high school. Congress has cooked up a complex array of tax benefits to help them do that. This brochure attempts to give a very basic explanation of the menu of education benefits available for students who are in school or who have just graduated. It does not address the various planning options or tax consequences presented by the purchase of savings bonds or contributions to Coverdell Education Savings Accounts, or Qualified Tuition Savings Programs (529 plans). Nor does it address all the issues surrounding students who may be taken as dependents on another person's return. Instead, it focuses on students who are currently in school or just graduated, who file their own returns, and who are not taken as dependents on another person's return. Finally, it does not set out all the rules pertaining to each benefit. IRS Publication 970 "Tax Benefits for Education" is a very nice comprehensive 80 page booklet that goes into much greater detail. Pub 970 can be found at http://www.irs.gov/formspubs.

Over the years, Congress has created a menu of tax benefits to help nourish taxpayers' education. Much like menus are divided into Appetizers, Entrees and Desserts, tax benefits fall into three broad groups: "exclusions," "deductions," and "credits." Part I of this brochure will explain what those terms mean. Part II will then describe benefits and requirements of each dish in the menu. Part III will discuss how the various tax benefits interact and point out opportunities as well as traps.

Part I: Organization of the Menu: Exclusions, Deductions, and Credits

The menu of tax benefits is made up of exclusions, deductions, and credits. Each works differently. To take full advantage of these benefits, one must understand how they work.

Exclusions allow a taxpayer to receive certain income without having to report it to the IRS as income. They indirectly reduce tax. One common example of an exclusion is a gift. If a parent gives $1,000 to a child, the child does not have to report or pay tax on that $1,000, even though it enriches the child in the same way money from any other source does. If the child would otherwise have paid $150 tax on that $1,000 in income, then the $1,000 exclusion saves the child $150. That is, the tax benefit of the exclusion is worth $150 to the child.

Deductions allow a taxpayer to subtract certain expenses from the income they report. Like exclusions, deductions indirectly reduce tax. One common example of a deduction is a charitable deduction. If a taxpayer gives $1,000 to qualified charities, the taxpayer can subtract that $1,000 from income if the taxpayer chooses to itemize deductions. This reduces income by

$1,000. So if the taxpayer would have otherwise paid $150 tax on that $1,000 income, then the $1,000 deduction saves the taxpayer $150. That is, the tax benefit of the deduction is $150 to that taxpayer.

Unlike exclusions and deductions, tax credits do not reduce the income subject to tax; they instead reduce the tax itself. One common example of a credit is the child tax credit. For 2004 qualifying parents may reduce their taxes by $1,000 for each qualifying child under the age of 17. That is, the $1,000 credit saves $1,000 in tax. You can see how a dollar credited against tax saves much more money that a dollar that gets excluded or deducted from income.

Part II: The Dishes on The Menu

Some of the tax benefits on the menu are relatively simple dishes, others are quite complex. This part describes each benefit and it basic rules, conditions, and limitations. The section numbers refer to the sections of the Internal Revenue Code that provide the benefit.

A. Exclusions

Section 117: Qualified Scholarships. This benefit allows a student to exclude from income money received from scholarships or fellowships. It has three conditions.

Conditions. **First**, the student must be a degree candidate and must use the money for tuition, fees, books, or school supplies, and not anything else, like room, board or transportation. **Second**, the student must attend an eligible primary, secondary, or post-secondary degree-granting educational institution, which pretty much means all regular bricks-and-mortar schools, including vocational schools. **Third**, the money must not really be compensation, either for services typically performed by graduate students such as teaching or research, or for the past, present, or future services of the student to the person giving the scholarship. One exception to this third requirement is that educational institutions may give their employees tuition reduction benefits, including benefits to graduate students engaged in research or teaching. If the benefits are properly structured, the employees can exclude the tuition reduction from income.

Limitations. This exclusion is not limited as to amount. It is available to all taxpayers regardless of income level.

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Section 127: Employer Assistance. This benefit allows a student to exclude from income money received from an employer's educational assistance program. It has two conditions.

Basic Conditions. **First**, the student must use the money for tuition, fees, books, and similar items, and not anything else, like room, board or transportation. **Second**, the employer's educational assistance program must itself meet certain requirements, the most important being that it be written down and that it not discriminate in favor of only a few employees or company shareholders.

Limitations. This exclusion is limited to $5,250 per year. That is, students may exclude only up to $5,250 received from a qualified educational assistance program and must report as income any amounts above that limit. This benefit is available to all taxpayers regardless of income level. Currently, it is set to expire in 2010.

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Section 135: Qualified Savings Bonds. This benefit allows a student to exclude from income the interest paid on qualified U.S. Savings Bonds. It has three conditions.

Basic Conditions. **First**, the student must use the money for either tuition or fees, or else put the money into either a § 529 Qualified Tuition Program or a § 530 Coverdell ESA (see below). The tuition and fees may be those of the student, the student's spouse, or dependent. **Second,** the tuition and fees must be for attending a qualified higher education institution, which pretty much means any institution that qualifies to participate in the federal student aid program run by the Department of Education. **Third**, the taxpayer must have purchased an eligible U.S. Savings bond after turning 24 year old. Eligible U.S. Savings bonds are series EE bonds purchased after 1989, or series I bonds.

Limitations. This exclusion is not limited as to amount. It is not available to all taxpayers. Single taxpayers who make more than $59,850 may only be eligible for a reduced benefit and those who make more than $74,850 may not be eligible for any benefit. Married taxpayers who together make more than $89,750 may only be eligible for a reduced benefit and those who make more than $119,750 may not be eligible for any benefit. Currently, the benefit is not set to expire.

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Section 529: Qualified Tuition Programs. This benefit allows a student to exclude from income cash or in-kind benefits received from a Qualified Tuition Program (commonly called 529 Plans). In-kind benefits come from 529 prepaid tuition plans and cash benefits come from 529 savings plans. This benefit has three conditions.

Basic Conditions. **First**, the money must come from a Qualified Tuition Program. These are generally sponsored by state governments. One useful resource for information on choosing a 529 Plan is www.savingforcollege.com. **Second**, the money must be used for tuition, fees, books, supplies, and equipment. It may also be used for reasonable room and board for those students who attend school at least half-time. The money may not be used for transportation. The expenses must be those of the named beneficiary of the plan, which may be the student, the student's spouse, the student's dependents or their spouses, or the student's first cousin. **Third,** the expenses must be for attending a qualified higher education institution, which pretty much means any institution that qualifies to participate in the federal student aid program run by the Department of Education.

Limitations. This exclusion is limited to distributions from the qualified 529 Plan but is not otherwise limited in amount. It is available to all taxpayers, regardless of income levels. Currently, the exclusion is set to expire after 2010.

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Section 530: Coverdell Education Savings Account (ESA). This benefit allows a student to exclude from income cash distributions from a Coverdell ESA. It has two conditions.

Basic Conditions: **First**, the money must come from a qualified ESA. These are generally offered by most mutual fund companies and other private financial institutions. One useful resource for information on creating a qualified ESA is www.savingforcollege.com. **Second**, the money must be used for qualified education expenses. That basically means the money must be used for tuition, fees, books, supplies, and equipment, or else be transferred to a 529 Plan. It may also be used for reasonable room and board for those students who attend a qualified higher education institution at least half-time. The money may not be used for transportation. ***Most importantly***, and similar to the Section 117 tax benefits (described above), the money may be used for the costs of attending a public, private or religious elementary or secondary school, as well as for attending a higher education institution that qualifies to participate in the federal student aid program run by the Department of Education.

Limitations. This exclusion is limited to distributions from a qualified ESA but is not otherwise limited in amount. It is available to all taxpayers, regardless of income levels. Currently, certain important aspects of this tax benefit are set to expire after 2010, the most important one being that it would no longer apply to distributions used for elementary and secondary education expenses.

B. Deductions

Section 162: Trade or Business Deduction. This benefit allows a student to deduct from income any money spent on education, including tuition, fees, books, supplies, room, board, and transportation. It has two conditions, which essentially require the student to relate the education to some current employment, whether self-employment or as an employee.

Basic Conditions. **First**, the education must either (a) improve or maintain a skill necessary to the student's current employment, trade or business or (b) be required by the student's employer, or by some law or government regulation. **Second**, the education must not (a) meet the minimum requirements to qualify for the student's current employment, trade or business, or (b) qualify the student for a new trade or business. For example, students who complete law school and obtain a J.D. cannot deduct the costs of law school because the J.D. degree qualifies them to sit for the Bar Examination and to become a lawyer. This is so even they have no intention of becoming a lawyer but simply went to law school to improve their skills in another type of business, such as financial planning or accounting. On the other hand, doctors, lawyers, and other licensed professionals who must meet continuing education requirements to maintain their licenses may generally use this deduction for the cost of that continuing education.

Limitations. This deduction is not limited in amount. It is available to all taxpayers regardless of income level. Currently, it is not set to expire. Self-employed taxpayers report this deduction Schedule C; employees report it on Schedule A where it may be subject to further limitations. See Instructions for Form 1040.

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Section 221: Qualified Interest. This benefit allows a student to deduct from income the interest paid—including loan origination fees—on qualified education loans, for the life of the loan. It has three conditions.

Basic Conditions. **First**, the loan must be a qualified loan. This means that the loan may not come from an immediate family member or close relative, and the loan proceeds must be used for qualified expenses, which can include room and board as well as tuition, fees, books, and supplies. Qualified expenses may be those of the student, the student's spouse or dependent. **Second,** the expenses must be for attending, at least half-time, a qualified higher education institution, which pretty much means any institution that qualifies to participate in the federal student aid program run by the Department of Education. **Third**, the student must not be *actually* claimed as a dependent on another person's return. Students do not lose the deduction by refinancing the loan balance.

Limitations. This deduction is limited to $2,500 per year. This benefit is not available to all taxpayers. Single taxpayers who make more than $50,000, and married taxpayers who together make more than $100,000, might not be eligible for the full benefit and should read the 1040 instructions or see IRS Publication 970 "Tax Benefits for Education" available at http://www.irs.gov/formspubs. Currently, this benefit is set to expire after 2005.

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Section 222: Qualified Tuition. This benefit allows a student to deduct from income money spent on qualified tuition and related expenses. It has four conditions.

Basic Conditions. **First**, the student may only deduct money spent on tuition and academic fees, and may not deduct money spent on books, room, board, and non-academic fees such as student activity fees or athletic fees. The tuition and academic fees may be those of the student, the student's spouse, or dependent. **Second,** the expenses must be for attending a qualified higher education institution, which pretty much means any institution that qualifies to participate in the federal student aid program run by the Department of Education. **Third**, this deduction is not allowed for students who could *possibly* be claimed as a dependent on other taxpayer's return, regardless of whether the student is *actually* claimed as a dependent. This third condition is tricky. Students who want to take this deduction should read IRS TaxTopic 354 to be sure they cannot *possibly* be claimed as a dependent on another's return. See: http://www.irs.gov/taxtopics/tc354.html. **Fourth**, the student, if married, must file a joint return.

Limitations. The deduction is limited to $4,000 per year. Single taxpayers who make more than $65,000 may not be eligible for the full deduction and those who make more than $80,000 may not be eligible for any benefit. Married taxpayers who together make more than $130,000 may not be eligible for the full deduction and those who make more than $160,000 may not be eligible for any benefit. Taxpayers above these incomes should consult the 1040 instructions or see IRS Publication 970 "Tax Benefits for Education" available at http://www.irs.gov/formspubs

C. Credits

Currently, there are only two tax credits in the Code for education expenses. Both are found in Section 25A. In addition to the basic rules governing each credit, special rules govern the interplay of these two credits and the interplay of these credits with the exclusions and deductions listed above. This section just sets out the basic rules. Part III will address the interplay rules.

Section 25A(b): Hope. This benefit allows a student to reduce tax by up to $1,500. This is a credit that is allowed per student, so it may potentially be taken more than once on a return. It has six conditions.

Basic Conditions. **First**, only money used for tuition and academic fees qualifies as education expenses for this credit. Money spent on books, room, board, transportation, or non-academic fees such as student activity fees or athletic fees does not qualify for this benefit. The tuition and academic fees may be those of the student, the student's spouse, or dependent. **Second**, to claim the credit, a student must attend a qualified higher education institution for at least half-time for at least one academic semester during the year. Any institution that is eligible to participate in the federal student aid program run by the Department of Education qualifies. **Third**, the student must not actually be claimed as a dependent on another's return. **Fourth**, the credit may only be claimed twice, once for each of the first two years of post-secondary education. Thus, a student in year 3 or later of post-secondary education cannot claim the credit, regardless of whether the student or anyone else took advantage of the credit for the first two years. **Fifth**, the student, if married, must file a joint return. **Sixth**, a student convicted of a federal or state felony for drug possession or distribution may not claim the credit for the year of the conviction or for any later year.

Limitations. The credit is limited to $1,500 per student per year. Note that is it a "per student" credit. So if two students are married, they may each take this credit, if they otherwise qualify. The first $1,000 on qualified expenses generate a dollar-for-dollar credit, up to $1,000. The next $1,000 of qualified expenses generate a two-for-one credit: every two dollars of expenses generates one dollar of credit, up to $500. A student who spends at least $2,000 of qualified expenses thus gets the full benefit. Single taxpayers who make more than $42,000 may not be eligible for the full credit and those who make more than $52,000 may not be eligible for any credit. Married taxpayers who together make more than $85,000 may not be eligible for the full credit and those who make more than $105,000 may not be eligible for any credit. Taxpayers above these incomes should consult the 1040 instructions or see IRS Publication 970 "Tax Benefits for Education" available at http://www.irs.gov/formspubs. Taxpayers reporting this credit must file Form 8863.

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Section 25A(c): Lifetime Learning. This benefit allows a student a tax credit equal to 20% of the student's qualified education expenses to directly reduce the student's tax by up to $2,000. In other words, $10,000 in qualified expenses gets you $2,000 off your tax liability. Unlike the Hope Credit, this credit is a per return credit and so may be taken only once per return per year. This benefit has four conditions.

Basic Conditions. **First,** only money used for tuition and academic fees qualifies as education expenses for this credit. Money spent on books, room, board, transportation, or non-academic fees such as student activity fees or athletic fees does not qualify for this benefit. The tuition and academic fees may be those of the student, the student's spouse, or dependent. **Second**, to claim the credit, a student must take one or more courses from a qualified higher education institution during the year. Any institution that is eligible to participate in the federal student aid program run by the Department of Education qualifies. **Third**, the student must not actually be claimed as a dependent on another's return. **Fourth**, the student, if married, must file a joint return.

Limitations. The credit is limited to $2,000 per return. Note that this is a "per return" credit. So if two students are married, they may only claim this credit once on their joint return. The credit is calculated as 20% of qualified expenses, so a student does not receive any benefit from this credit after the first $10,000 in qualified expenses. Single taxpayers who make more than $42,000 may not be eligible for the full credit and those who make more than $52,000 may not be eligible for any credit. Married taxpayers who together make more than $85,000 may not be eligible for the full credit and those who make more than $105,000 may not be eligible for any credit. Taxpayers above these incomes should consult the 1040 instructions or see IRS Publication 970 "Tax Benefits for Education" available at http://www.irs.gov/formspubs. Taxpayers reporting this credit must file Form 8863.

Part III: Selecting From the Menu: The Interplay of Benefit Provisions

Sometimes, eating the wrong combination of foods produces indigestion...or worse. This part will (a) describe the basic rules for how students can mix and match the various tax benefits, and (b) suggest some ideas on how to select from the menu. Sometimes students will have a choice in what benefits to select. Other times, they will not have a choice.

A. Interplay of Tax Benefits

Rules for Interplay of Exclusions with Deductions. The overarching basic principle is that a single dollar of education expense cannot generate more than one tax benefit. For example, a student who uses a $10,000 scholarship to pay for tuition in a single year, and who qualifies for both the § 117 Qualified Scholarship exclusion and the § 222 Qualified Tuition deduction, may not use both benefits for the same dollars. That is, the student may not exclude the $10,000 from income and then also deduct $4,000 of it from other income. In addition, students must generally use the exclusion benefits before they may use the deduction benefits. For example, students who cash a qualified U.S. savings bond, or receive a distribution from a § 529 plan or Coverdell ESA, cannot claim a deduction under § 222 for the amount of the distribution that is excluded from income under another provision.

Rules for Interplay of Credits with Each Other. Students may not use both the Hope and Lifetime Learning credit in the same year for the same student. If a student qualifies for both credits, the student may choose whichever benefit is better. Generally that means taking the Hope credit if a student has less than $7,500 in eligible expenses and taking the Lifetime Learning credit if a student has more than $7,500 in eligible expenses. However, taxpayers who have paid qualified education expenses for more than one student who meets the requirements for both the Hope and Lifetime Learning credits—such as married students—may (a) claim two Hope credits (one for each student), or (b) claim one Hope credit and one Lifetime Learning Credit. Remember that since the Lifetime Learning credit is limited to one credit per return, the taxpayers in this example could not claim two Lifetime Learning credits.

Rules for Interplay of Credits with Exclusions. Money that can be excluded from income under one of the education benefit exclusions listed above cannot be used to generate either the Hope or Lifetime Learning credits. That is, students may not choose to use a credit instead of an exclusion for money that qualifies for exclusion, but must use the exclusion benefits.

Rules for Interplay of Credits with Deductions. Money that can be deducted from income under either § 162 (Trade or Business) or § 222 (Qualified Tuition) may be used instead to generate either the Hope or Lifetime Learning credits. For money that qualifies for deduction under § 162, students may also choose to mix the benefits, using the credit up first and then taking a deduction for any money that was not used to generate the credit. However, for money that qualifies for deduction under § 222, students may not choose to mix the benefits; they must instead choose either the deduction or the applicable credit. For example, a student who spends $15,000 on tuition in a year and meets the requirements of both the § 162 deduction and the Lifetime Learning credit, may choose to use $10,000 of the money spent to generate a $2,000 credit, and then may deduct the remaining $5,000 from other income. In contrast, a student who spends $15,000 on tuition in a year and meets the requirements of both the § 222 deduction and the Lifetime Learning credit, must choose to take either the credit or the deduction. Since the § 222 deduction is limited to $4,000, the credit will generally save more money.

Special Rule for Qualified Interest Deduction. Students may take the § 221 Qualified Interest deduction even if the student also received another tax benefit from using the loan proceeds. For example, a student who uses a $10,000 loan to pay tuition, and who otherwise qualifies for both the Qualified Interest deduction and the Lifetime Learning credit, may take a $2,000 tax credit and then still deduct the interest payments on the loan for the life of the loan.

B. Selecting From the Menu

One will notice a wide variation in tax benefits for different types of expenses. While all the educational tax benefits apply to money spent for tuition and most (except for Section 117) apply to money spent for academic fees, fewer apply to money spent for non-academic fees, books, and supplies, and even fewer apply to money spent for room, board, and transportation, and only two apply to money spent on elementary or secondary education. Students should therefore consider what source of funds they use for what purpose. Generally speaking students should try to pay for tuition and academic fees from money that would not qualify for exclusion or deduction, and should try to pay for expenses that do not qualify for the Hope or Lifetime Learning credits with money that does qualify for another tax benefit or which qualify only for the § 221 Qualified Interest benefit.

As an example, assume that Sam Student is a single taxpayer whose income for the year will be $40,000. He plans to spend $40,000 on education as follows: $25,000 for tuition; $1,000 for academic fees; $1,000 for non-academic fees such as health fee, activities fee, insurance, athletic fee, etc.; $3,000 for books and required school supplies (including a laptop computer); and $10,000 for room and board. To scrape together this awesome amount, Sam looks to the following sources: $10,000 gift from parents; $5,000 in money from wages saved in a regular bank account; $5,000 from a 529 Plan; and the remaining $20,000 from a financial aid package consisting of a $5,000 scholarship, a $5,000 Stafford loan, a $3,000 Perkins loan, and a $7,000 private loan.

How can Sam best use the education tax benefits for students? What choices does Sam have? First, Sam should use the financial aid scholarship money to pay for the books and supplies and the student fees, starting with the required non-academic fees that would not qualify as expenses for the tax credits but do qualify for the § 117 Qualified Scholarship exclusion. In contrast, if Sam had used the $5,000 scholarship money to pay for room and board, Sam would have been required to include that amount in income for the year and pay taxes on it. Second, Sam should pay for as much of the tuition as possible from funds that do not qualify for any other education tax benefit. Sam can then choose either the Lifetime Learning credit or the § 222 Qualified Tuition deduction. Since Sam will earn only $40,000 for the year and so can take full advantage of the Lifetime Learning credit, that is the logical choice. If Sam earned more than $52,000 for the year, the Lifetime Learning credit would not be available and in that case Sam would take the much less powerful § 222 deduction. Either way, Sam should use the savings, the gift money, and part of the loan proceeds to pay for tuition. Third, Sam should pay for room and board with money that qualifies for a tax benefit where room and board are qualified education expenses. Here that would be Sam's loans and 529 Plan distribution. Following this advice, Sam would be able to (a) exclude the $5,000 scholarship from income, (b) deduct interest payments (up to $2,500 per year) made on the Stafford loan, both for the current year and any future years where Sam's income does not limit this benefit, and (c) reduce the final tax liability for the year by the full $2,000 Lifetime Learning credit. By making the right decisions and elections, Sam can save at least $3,250 in taxes (being the $2,000 credit, plus the $1,250 in taxes saved by not having to include the scholarship money in income—interest payments on loans may or may not be payable while Sam is still a student).

After reviewing the myriad rules and exceptions that Sam must study, one can conclude that this complex menu of tax benefits for education certainly gives taxpayers food for thought, in more ways than one!