

## **Tax Benefits for Higher Education Summary of Provisions**

Joseph F. Hurley CPA  
Savingforcollege.com LLC  
www.savingforcollege.com  
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### 1. Trade or business deduction for education expenses

Code section: 162

Benefit: Miscellaneous itemized deduction for education expenses incurred in a trade or business

Requirements and limitations:

- Education or training must (1) maintain or improve a skill required in a trade or business currently engaged in by the taxpayer, or (2) meet the express requirements of the taxpayer's employer, or requirements of applicable law or regulations, imposed as a condition of continued employment.
- Not deductible if expenses relate to certain minimum educational requirements or to education or training that enables a taxpayer to begin working in a new trade or business

### 2. Hope credit

Code section: 25A

Benefit: Nonrefundable credit of up to \$1,500 per student per year for qualified tuition and related expenses paid for the first two years of the student's post-secondary education in a degree or certificate program

Requirements and limitations:

- Rate is 100 percent on the first \$1,000 of qualified tuition and related expenses, and 50 percent on the next \$1,000
  - Each of the \$1,000 amounts are indexed to inflation, with the amount rounded down to the next lowest multiple of \$100
- Phased out ratably for taxpayers with modified adjusted gross income between \$42,000 and \$52,000 (\$85,000 and \$105,000 for married taxpayers filing a joint return) for 2004
  - Phase-out ranges are indexed for inflation
- Qualified tuition and related expenses must be incurred on behalf of the taxpayer, the taxpayer's spouse, or a dependent of the taxpayer
- Taxpayer may claim the credit with respect to a student who is not the taxpayer or the taxpayer's spouse only if the taxpayer claims the student as a dependent; if the student is claimed as a dependent of another, the taxpayer claiming the student as a dependent is treated as paying the qualified tuition and related expenses

- Credit is available with respect to an individual student for two taxable years, provided the student has not completed the first two years before the beginning of the second taxable year
- Expenses must be paid within the calendar year and education must be furnished during that year or within the first three months of the next year
- Expenses include tuition and fees (excluding nonacademic fees) required to be paid to an eligible educational institution as a condition of enrollment or attendance of an eligible student at the institution; does not include meals, lodging, insurance, transportation, and similar personal, living, or family expenses; does not include expenses of education involving sports, games, or hobbies unless part of the student's degree program
- Student must be enrolled at least half-time in a degree, certificate, or other program leading to a recognized educational credential at an eligible educational institution
- Student must not have been convicted of a federal or state felony consisting of the possession or distribution of a controlled substance
- An eligible institution must be eligible to participate in Department of Education student aid programs

### 3. Lifetime Learning credit

Code section: 25A

Benefit: Nonrefundable credit of up to \$2,000 per taxpayer return for qualified tuition and related expenses paid for the first two years of the student's post-secondary education in a degree or certificate program

Requirements and limitations:

- Rate is 20 percent on up to \$10,000 of qualified tuition and related expenses
  - Amount is not indexed for inflation
- Phased out ratably for taxpayers with modified adjusted gross income between \$42,000 and \$52,000 (\$85,000 and \$105,000 for married taxpayers filing a joint return) for 2004
  - Phase-out ranges are indexed for inflation
- Qualified tuition and related expenses must be incurred on behalf of the taxpayer, the taxpayer's spouse, or a dependent of the taxpayer
- No limit on number of years credit can be claimed
- Expenses must be paid within the calendar year and education must be furnished during that year or within the first three months of the next year
- Taxpayer may claim the credit with respect to a student who is not the taxpayer or the taxpayer's spouse only if the taxpayer claims the student as a dependent; if the student is claimed as a dependent of another, the taxpayer claiming the student as a dependent is treated as paying the qualified tuition and related expenses
- Expenses include tuition and fees (excluding nonacademic fees) required to be paid to an eligible educational institution as a condition of enrollment or attendance of a student at the institution; does not include meals, lodging, insurance, transportation, and similar personal, living, or family expenses; does not include expenses of education involving sports, games, or hobbies unless part

- of the student's degree program; does include tuition and fees with respect to undergraduate or graduate-level (and professional degree) courses
  - Student can be enrolled less than half-time, and can be attending the institution to acquire or improve job skills; non-degree programs are allowable
  - An eligible institution must be eligible to participate in Department of Education student aid programs
4. Above-the-line deduction for certain higher education expenses

Code section: 222

Benefit: An above-the-line deduction for qualified tuition and related expenses for higher education paid by the individual during the taxable year

Requirements and limitations:

- Qualified tuition and related expenses are defined in the same manner as for the Hope and Lifetime Learning credits
  - For 2004 and 2005, the maximum deduction is \$4,000 for an individual whose adjusted gross income does not exceed \$65,000 (\$130,000 in the case of a joint return), or \$2,000 for other individuals whose adjusted gross income does not exceed \$80,000 (\$160,000 in the case of a joint return)
  - Deduction ends after 2005
  - No deduction allowed to an individual whose adjusted gross income exceeds the relevant adjusted gross income limitations, a married individual who does not file a joint return, or an individual with respect to whom a personal exemption deduction may be claimed by another taxpayer for the taxable year
  - No deduction with respect to an individual for whom a Hope credit or Lifetime Learning credit is elected
5. Exclusion for employer-provided educational assistance

Code section: 127

Benefit: Up to \$5,250 annually of educational assistance (graduate and undergraduate) provided by an employer to an employee is excludable from income and wages

Requirements and limitations:

- Educational assistance must be provided pursuant to a separate written plan of the employer
  - Must not discriminate in favor of highly compensated employees
  - No more than five percent of benefits can be provided to five-percent owners and their spouses and dependents
- May pay for tuition, fees and similar payments, books, supplies, and equipment
  - Does not include (1) tools or supplies that may be retained by the employee, (2) meals, lodging, or transportation, and (3) any education involving sports, games, or hobbies
- Exclusion does not apply to education provided to employee's spouse or child
- Distinguish Section 132(d) exclusion for education provided as a working condition fringe
  - 2 percent threshold on miscellaneous deductions does not apply

- Exclusion scheduled to expire after 2010 under the general sunset provision of EGTRRA
6. Qualified scholarships

Code section: 117

Benefit: Amounts received as a qualified scholarship are excluded from gross income and wages

Requirements and limitations:

- Individual must be a candidate for a degree
- Must be used for tuition and fees required for enrollment or attendance (or for fees, books, supplies, and equipment required for courses of instruction) at a primary, secondary, or post-secondary educational institution
- Does not cover regular living expenses, such as room and board
- Exclusion does not apply to payments for teaching, research, or other services by the student required as a condition for receiving the scholarship or tuition reduction

7. Qualified tuition reduction

Code section: 117(d)

Benefit: Qualified tuition reductions for certain education provided to employees of certain educational organizations (and their spouses and children) are excluded from gross income and wages

8. Qualified tuition programs

Code section: 529

Benefit: Earnings accumulate tax-free and distributions used to pay qualified higher education expenses are excluded from gross income; contributions are completed gifts from the donor to the beneficiary despite continuing control and ownership by the donor, and a five-year spreading election is available to the donor in any year that total contributions for a particular beneficiary exceed the annual exclusion amount

Requirements and limitations:

- Qualified higher education expenses means tuition, fees, books, supplies, and equipment required for the enrollment or attendance of a designated beneficiary at an eligible educational institution, and expenses for special needs services in the case of a special needs beneficiary that are incurred in connection with such enrollment and attendance
- Qualified higher education expenses also include room and board for students who are enrolled at least half-time and are candidates for a degree
- Room and board is limited to the greater of (1) the allowance applicable to the beneficiary for room and board included in the cost of attendance as defined in section 472 of the Higher Education Act as in effect on June 7, 2001, as determined by the eligible educational institution for that period, or (2) the actual

invoice amount the beneficiary residing in housing owned and operated by the institution is charged for room and board for that period

- The earnings portion of a nonqualified distribution is taxable to the distributee as ordinary income and subject to a 10% additional tax (certain exceptions apply to the 10% tax)
- The tax exclusion sunsets on December 31, 2010; qualified distributions after that date are reported to the designated beneficiary and earnings taxed to the designated beneficiary
- There can be only one same-beneficiary rollover from one 529 plan to another in any 12-month period; rollovers involving a change of beneficiary to another family member are not restricted
- A participant may not be given the ability to directly or indirectly direct the investments in the program; IRS permits programs to allow an investment change within a program once every calendar year, or at any time the beneficiary of the account is changed to another family member

#### 9. Coverdell education savings accounts

Code section: 530

Benefit: Earnings accumulate tax-free and distributions used to pay qualified education expenses are excluded from gross income

Requirements and limitations:

- Qualified education expenses includes (1) qualified higher education expenses, defined the same as under section 529, and (2) qualified elementary and secondary education expenses, which means expenses for (a) tuition, fees, academic tutoring, special needs services, books, supplies, and other equipment incurred in connection with the enrollment or attendance of the beneficiary at a public, private, or religious school for kindergarten through grade 12, (b) room and board, uniforms, transportation, and supplementary items or services (including extended day programs) required or provided by such a school, and (c) the purchase of any computer technology or equipment or Internet access and related services, if to be used by the beneficiary and family during any of the years the beneficiary is in elementary or secondary school
- Does not include computer software involving sports, games, or hobbies unless predominantly educational in nature
- Annual contributions may not exceed \$2,000 per designated beneficiary and may not be made after the designated beneficiary reaches age 18 (except in the case of a special needs beneficiary)
- The contribution limit is phased out for contributors with modified adjusted gross income between \$95,000 and \$110,000 (\$190,000 and \$220,000 for married taxpayers filing a joint return)
- The earnings portion of a nonqualified distribution is taxable to the distributee as ordinary income and subject to a 10 percent additional tax (certain exceptions apply to the 10 percent penalty)
- Any balance remaining is deemed to be distributed within 30 days after the date the beneficiary reaches age 30, and is subject to tax and 10 percent penalty

- Certain changes made by EGTRRA are scheduled to expire at the end of 2010; the most critical is the change permitting a Hope and Lifetime Learning credit to be claimed in the same year ESA withdrawals are made using the exclusion

#### 10. Exclusion of interest on education savings bonds

Code section: 135

Benefit: Interest earned on a qualified U.S. Series EE or I savings bond is excludable from gross income if the proceeds of the bond redemption do not exceed qualified higher education expenses paid by the taxpayer during the taxable year

Requirements and limitations:

- The bond must have been issued after 1989 to a bondholder at least 24 years old in the month prior to bond issuance
- Qualified higher education expenses include tuition and fees (but not room and board) required for the enrollment or attendance of the taxpayer, the taxpayer's spouse, or a dependent of the taxpayer at an eligible higher education institution
- Exclusion is phased out for certain high-income taxpayers, determined by the taxpayer's modified gross income during the year the bond is redeemed; for 2004, the exclusion is phased out for single taxpayers with modified adjusted gross income between \$59,850 and \$74,850 (\$89,750 and \$119,750 for married taxpayers filing a joint return)

#### 11. Penalty exception on early withdrawals from traditional and Roth IRAs

Code section: 72(t)(2)(E)

Benefit: An exception to the 10-percent early withdrawal penalty for qualified higher education expenses of the taxpayer, the taxpayer's spouse, or any child or grandchild or the taxpayer and his or her spouse

Requirements and limitations:

- Same definition of qualified higher education expenses as section 529

#### 12. Deduction for student loan interest

Code section: 221

Benefit: An above-the-line deduction for interest paid on qualified education loans

Requirements and limitations:

- Maximum allowable deduction is \$2,500
- Deduction in 2004 is phased out for single taxpayers with adjusted gross income between \$50,000 and \$65,000 and between \$105,000 and \$135,000 for married taxpayers filing a joint return
- No deduction allowed to an individual claimed as a dependent on another taxpayer's return
- Qualified education loan is any indebtedness incurred solely to pay for the costs of attendance (including room and board) of the taxpayer, the taxpayer's spouse, or any dependent of the taxpayer in attending an eligible educational institution on at least a half-time basis

### 13. Exclusion of income from student loan forgiveness

Code section: 108(f)

Benefit: Gross income does not include any amount from the forgiveness of certain student loans, provided that the forgiveness is contingent on the student's working for a certain period of time in certain professions

### 14. Gift tax exclusion for direct payment of tuition

Code section 2503(e)

Benefit: The direct payment of tuition by anyone on behalf of another to a school is excluded from the definition of a gift

Requirements and limitations:

- Applies only to tuition, not to other education costs
- Mortality risk is a factor when planning to use this exclusion

For more information:

Internal Revenue Service, *Publication 970: Tax Benefits for Education*, available online at [www.irs.gov](http://www.irs.gov)

Hurley, Joseph and Kaye A. Thomas, *2004 Year End Planning for Education Tax Benefits*, order online at [www.savingforcollege.com](http://www.savingforcollege.com)

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Joseph F. Hurley CPA

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## College Costs

	TFRB	1-yr increase	10-yr increase
4-yr public	\$11,354	7.8%	71.5%
2-yr public	\$2,076*	8.7%	66.7%
4-yr private	\$27,516	5.6%	66.8%

Source: Trends in College Pricing 2004, The College Board

\* Tuition and fees only

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## Independent 529 Plan

- 240+ private colleges
- Prepay tuition at less than current cost
- Refund: contributions plus or minus no more than 2% annualized
- [www.independent529plan.org](http://www.independent529plan.org)

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## Fed Financial Aid

	Asset Treatment	Income Treatment
UTMA	35%	Max 50%, gains only
Parent-owned 529 for student	Max 5.6%	None
Student-owned 529	35%	None
Grandparent-owned 529	None	Max 50%, entire w/d
Parent-owned 529 for sibling	??	None
Coverdell ESA	Max 5.6%?	None

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## Before the 2003 Tax Cuts

	Expense	18-Yr Accumulation	
529 Plan	65 bps	61,248	
Mutual Fund	65 bps	53,121	
UTMA	65 bps	58,775	
Mutual Fund	18 bps	55,032	
UTMA	18 bps	61,264	

Source: TIAA-CREF Institute

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## After the 2003 Tax Cuts

	Expense	18-Yr Accumulation	
529 Plan	65 bps	61,248	61,248
Mutual Fund	65 bps	53,121	54,584
UTMA	65 bps	58,775	60,752
Mutual Fund	18 bps	55,032	56,691
UTMA	18 bps	61,264	63,572

Source: TIAA-CREF Institute

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## Multiple 5-Year Elections

	Year 1	Year 2	Year 3	Total
Contribution	30,000	25,000	15,000	70,000
For gift tax:				
Year 1	6,000			6,000
Year 2	6,000	5,000		11,000
Year 3	6,000	5,000	3,000	14,000
Year 4	6,000	5,000	3,000	14,000
Year 5	6,000	5,000	3,000	14,000
Year 6		5,000	3,000	8,000
Year 7			3,000	3,000

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## Tax Deferral

Current:

No limit on tax deferral

Proposed:

Account must be distributed  
when beneficiary reaches  
age 35

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## **Non-qualified withdrawals**

**Current:**

**Tax and 10% penalty on  
earnings**

**Proposed:**

**35% excise tax between  
\$50,000 - \$150,000**

**50% excise tax above  
\$150,000**

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## **Estate Planning**

**Current:**

**Remove asset but keep full  
ownership**

**Proposed:**

**Give up ownership; remain  
custodian for beneficiary**

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## **Gift Tax**

Current:

Deemed gift from old  
beneficiary to new lower-  
generation beneficiary

Proposed:

No deemed gifts

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## **Qualified Distributions**

Current:

Tax exclusion sunsets in 2010

Proposed:

Tax exclusion is made  
permanent

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## Tax Rate Sunsets

Differences in account balances: 529 plan (with 0.50% program expense) versus taxable mutual funds

<b>529 sunsets?</b>	<b>JGTRRA sunsets?</b>	<b>35% bracket</b>	<b>15% bracket</b>
<b>No</b>	<b>Yes</b>	<b>\$17,005 (12%)</b>	<b>\$2,181 (1%)</b>
<b>No</b>	<b>No</b>	<b>\$10,894 (7%)</b>	<b>-\$5,847 (-3%)</b>
<b>Yes</b>	<b>No</b>	<b>\$3,156 (2%)</b>	<b>-\$13,585 (-8%)</b>

\* See accompanying worksheet for assumptions used in these calculations.

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## Other Proposals

- Lifetime Savings Accounts
- Remove income limit on Coverdell ESA
- Uniform definition of qualified higher education expenses
- Uniform definition of “child”
- Expansion of Lifetime Learning credit

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## **State Taxes and 529**

- Check on deduction limitations
  - Carryover of excess contributions?
  - Relationship of donor?
  - Rollover contributions?
  - Recapture provisions?
- Check on withdrawal status
  - Statutory exemption versus federal conformity
  - In-state versus out-of-state 529 plan

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## **Coordination of Tax Incentives**

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## **Mutually Exclusive Benefits**

Hope credit  
vs  
Lifetime Learning credit  
vs  
Above-the-line tuition deduction

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## **LLC beats Hope**

**\$2,000 vs. \$1,500**

Possible exceptions:

- Tuition/fees are less than \$7,500
- Multiple family members in college
- Paying tuition with 529 or ESA \$\$
- Multi-year bunching strategy

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## Deduction vs Credit

For credit-eligible taxpayer:

	Tax rate or equivalent	Limit on tuition/fees
Above-the-line deduction	25%	\$4,000
Lifetime Learning	20%	\$10,000
Hope credit	75%	\$2,000

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## Other Decisions

- **Scholarship**
  - Tax-free scholarship reduces creditable or deductible expenses
  - Consider reporting scholarship as taxable
- **Sec. 162 business deduction**
  - Business education expenses do not qualify for Hope/LLC, above-the-line deduction, or for tax-free ESA
  - Still counts for tax-free 529 treatment

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## Credit Adjustment to QHEE

1. Qualified Higher Education Expenses, minus ...
2. Tuition and related expenses applied to Hope or LLC, equals ...
3. QHEE for 529 and ESA purposes

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## Coordinating HC/LLC with 529/ESA

	Total	LLC	529/ESA
Tuition and fees	12,000	10,000	2,000
Room and board	10,000	N/A	10,000
Books, supplies, equipment	1,000	N/A	1,000
<b>Total</b>	<b>23,000</b>	<b>10,000</b>	<b>13,000</b>

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## Coordinating Sec. 222 with 529/ESA

	Total	529*	Sec 222
Tuition and fees	4,000	2,000	2,000
Room and board	5,000	2,500	N/A
Books, supplies, equipment	1,000	500	N/A
Total	10,000	5,000	2,000

\*Assumes 50% earnings ratio

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**The 529 Expense Analyzer SM**

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**Assumptions:**

Initial investment: \$5,000 on August 1, 2004

Additional periodic investment: \$5,000 on January 1 each year

Asset allocation:

60% equity (2% annual dividend, 2% LTCG distribution, 3% unrealized appreciation)

40% fixed income (4% annual interest)

Withdrawals: over four years beginning 2022

Federal tax rates:

Account owner: 35% or 15%

Beneficiary: 10%

State tax rates:

Account owner: none

Beneficiary: none

529 program management fee: 0.50%

529 account maintenance fee: \$25 annual

**Scenarios:**

	#1	#2	#3	#4	#5	#6
Owner tax rate:	35%	35%	35%	15%	15%	15%
Does 529 exclusion sunset in 2010?	No	No	Yes	No	No	Yes
Do JGTRRA rates sunset in 2008?	Yes	No	No	Yes	No	No

**Results:**

	#1	#2	#3	#4	#5	#6
Total contributions	\$90,000	\$90,000	\$90,000	\$90,000	\$90,000	\$90,000
Total benefits:						
Taxable	\$146,704	\$152,815	\$152,815	\$161,528	\$169,556	\$169,556
529 plan	\$163,709	\$163,709	\$155,971	\$163,709	\$163,709	\$155,971
529 (dis)advantage	\$17,005	\$10,894	\$3,156	\$2,181	-\$5,847	-\$13,585
% (dis)advantage	11.59%	7.13%	2.07%	1.35%	-3.45%	-8.01%

**Nonqualified withdrawal to account owner:**

	#1	#2	#3	#4	#5	#6
529 plan	\$128,886	\$128,886	\$128,886	\$144,363	\$144,363	\$144,363
529 plan (dis)advantage	-\$17,818	-\$23,929	-\$23,929	-\$17,165	-\$25,193	-\$25,193
% advantage	-12.15%	-15.66%	-15.66%	-10.63%	-14.86%	-14.86%

**Nonqualified withdrawal to beneficiary (assume 10% beneficiary tax bracket)**

	#1	#2	#3	#4	#5	#6
529 plan	\$148,232	\$148,232	\$148,232	\$148,232	\$148,232	\$148,232
529 plan (dis)advantage	\$1,528	-\$4,583	-\$4,583	-\$13,296	-\$21,324	-\$21,324
% (dis)advantage	1.04%	-3.00%	-3.00%	-8.23%	-12.58%	-12.58%