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Note: Student loan interest is not limited to government student loans and could be home equity loans, credit card debt, etc., provided the debt was incurred solely to pay qualified higher education expenses.

The annual deduction begins to phase out when modified AGI reaches the threshold amount and is fully phased out when the modified AGI reaches the top of the phase-out range. The phase-out ranges are inflation adjusted in $5,000 increments. For example, the 2009 and 2010 ranges are between $60,000 and $75,000 for single taxpayers and between $120,000 and $150,000 for joint return filers. Please call this office for other years' phase-out levels.

Educational Tax Credits

The law provides for two nonrefundable tax credits, the Hope Scholarship and the Lifetime Learning Credits, as explained on the following panel. Both credits will reduce a taxpayer's tax liability dollar for dollar until the tax reaches zero. Any credit in excess of the tax liability is lost. The credit is not allowed for taxpayers who file married separate returns.

The credits are elective, and the taxpayer must choose between the two credits for each student. In general, most taxpayers will find it more beneficial to take the Hope Scholarship Credit in the first two years of the student's education and the Lifetime Learning Credit after the first two years.

The allowable credits phase out when a taxpayer's modified AGI reaches the threshold amount and is fully phased out when the modified AGI reaches the top of the phase-out range. These phase-out levels are annually adjusted for inflation. The phase-out amounts for 2008 are between $50,000 and $60,000 for unmarried taxpayers and twice those amounts for joint filing couples. Please call this office for the current phase-out levels after 2008.

Hope Scholarship Credit

For 2009 and 2010, the Hope Credit does not apply. Instead, the more liberal American Opportunity Credit applies. See American Opportunity Credit later.

The Hope Scholarship Credit is an inflation adjusted credit of up to $1,500 ($1,800 beginning in 2008) per student per year, covering the first two years of post-secondary education. The credit is 100% of the first $1,000 ($1,200 beginning in 2008) of qualifying expenses plus 50% of the next $1,000 ($1,100 in 2008).

Example: In 2008, a taxpayer's child is in the first year of college, attending on a full-time basis. The tuition is $1,500, which is paid during the year by the taxpayer; there is no reimbursement or other tax benefit claimed for the tuition expense. The taxpayer is entitled to a tax credit of $1,350 (100% of the first $1,200 plus 50% of balance) for the tax year.

American Opportunity Tax Credit

The American Opportunity Tax Credit replaces the Hope Credit for 2009 and 2010. It provides a credit for four years (as opposed to the first two years for the Hope credit) of college expenses, and the maximum credit per student increases to $2,500 per year. The credit will be based on 100% of the first $2,000, and 25% of the next $2,000, of tuition, fees and course material (including books) expenses paid during the tax year. 40% of the credit is refundable, provided the taxpayer is not: (1) a child under the age of 18 or (2) under the age of 24, a full-time student and is not self-supporting. For higher-income taxpayers, this credit begins to phase out for AGI in excess of $80,000 ($160,000 for married couples filing jointly), a significant increase from the previous phase-out thresholds noted previously. This enhanced credit can be used to offset the alternative minimum tax in both 2009 and 2010.

Lifetime Learning Credit

The Lifetime Learning Credit is a credit of up to 20% of the first $10,000 of qualifying educational expenses for: (1) undergraduate, graduate, or certificate level courses for a student attending classes on at least a half-time basis; or (2) any course at an eligible institution to acquire or improve job skills of the student (no attendance time requirements).

Example: A taxpayer has two children attending college on a full-time basis. The taxpayer pays qualified tuition expenses for the two children in the amount of $12,000, and there is no reimbursement or other tax benefit claimed for the tuition expense. The taxpayer is entitled to a tax credit of $2,000 (20% of the first $10,000) for the tax year.

Qualifying expenses... for these credits include tuition and fees but not expenses for room, board, books, and other nonacademic fees such as student activity, athletic, insurance, etc. Also excluded are expenses for courses that involve sports, games, or hobbies that are not part of a degree program. Expenses qualifying for the credit must be reduced by tax-free scholarships or fellowships and other tax-free educational benefits.

Qualifying students... must attend a qualified educational institution (one that is eligible to participate in U.S. Dept. of Education student aid programs). The student must be the taxpayer, his or her spouse, or someone who is a dependent of the taxpayer. In addition, in the case of the Hope Scholarship Credit, the student must have no federal or state felony drug convictions for the academic period to which the credit would apply.

Savings Bond Interest Exclusion

Interest earned on U.S. savings bonds is, by federal law, excludable from taxation for state income tax purposes but taxable on the federal return. However, for certain savings bonds, an individual can even exclude the interest on the federal return. To qualify for this Federal exclusion, the bonds must be Series EE U.S. savings bonds issued after 1989, or a series I Bond and the bond proceeds must be used to pay higher education expenses.

Other qualifications... The bond purchaser must be age 24 or over and must be the sole owner of the bond (or, if married, joint owner with a spouse). Bonds purchased by others (except the spouse) or purchased by the taxpayer and placed in another's name do not qualify for the exclusion.

Redemption of bonds... When the bonds are redeemed, the interest earned is excludable from income to the extent the proceeds are used to pay qualified higher education expenses for the taxpayer, spouse, or any dependent of the taxpayer. Such expenses include tuition and fees but not room and board or courses involving sports, etc., that aren't part of a degree program.

Phase out... Like so many of the other educational benefits described earlier in this brochure, the interest exclusion phases out when modified AGI is between certain inflation-adjusted limits. For 2009, the phase-out occurs between $69,950 and $84,950 for single taxpayers and between $104,900 and $134,900 for married taxpayers filing joint returns. For phase-out levels for other years, please call this office.

Above-the-Line Education Deduction

A deduction from gross income of up to a maximum of $4,000 is allowable for higher education tuition expenses (same definition as for the education credits). This deduction is phased out for higher-earning taxpayers and is not allowed in years when education credits are claimed. This deduction was scheduled to expire several times and each time Congress extended it. At the time this brochure was printed, the deduction had been extended through 2009. For years after 2009, please call this office for further information.

The advice included in this brochure is not intended or written by this practitioner to be used, and it cannot be used by a practitioner or taxpayer, for the purpose of avoiding penalties that may be imposed on the practitioner or taxpayer.

Tax Breaks for Higher Education

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Tax Breaks for Higher Education

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Over the years, Congress has continued to enhance tax breaks for students and their parents. These tax benefits provide taxpayers with a large number of options for tax-favored financing of their education and the education of their family members. This brochure highlights the various education benefits included within the U.S. income tax system.

- **Coverdell Education Savings Account (Education IRA)**
- **Qualified State Tuition Program**
- **Hope Scholarship Program** (American Opportunity Credit in 2009 and 2010)
- **Lifetime Learning Credit**
- **Penalty-Free IRA Withdrawals for Education Purposes**
- **Deduction for Education Loan Interest**
- **Tax-Free Savings Bond Interest**

Student aid is available from the Department of Education for students of limited means. The aid can include educational grants such as a "Pell" grant or various types of student and parent educational loans. Planning and saving for future education can limit or eliminate potential student aid, because these resources will be taken into consideration at the time the need for student aid is determined.

Understanding the tax terms: You will encounter several tax terms in this brochure that may be unfamiliar to you. Understanding their full meaning will help give you a better picture of the limits, qualifications, and restrictions that apply to the benefits for education.

Phase Out... Instead of just eliminating certain deductions and credits, the tax law often decreases them gradually to zero ("phases them out") over a specific income range. For example, say a hypothetical $1,000 deduction is allowed, but "phases out" when a taxpayer's "modified adjusted gross income (AGI)" is between $40,000 and $60,000. A taxpayer with a modified AGI of $40,000 or less will be allowed the full $1,000 deduction, while the taxpayer with a modified AGI of $60,000 or more would get no deduction. For modified AGIs between $40,000 and $60,000, the taxpayer would be allowed a pro-rated deduction amount.

Regular AGI and Modified AGI... AGI is the abbreviation for "adjusted gross income." "Regular AGI" is the total of all income, allowable losses, and adjustments before subtracting itemized or standard deductions and personal exemptions. However, several tax benefits described in this brochure are limited or not available to taxpayers whose so-called "modified AGI" is too high. Generally, the modified AGI for educational benefits adds back certain income from foreign, U.S. Possession, and Puerto Rican sources that is excluded from income.

Qualified Educational Institutions... These Institutions are generally accredited, post-secondary educational institutions that offer credit toward a bachelor's degree, an associate's degree, or some other recognized post-secondary credential. Certain proprietary institutions and post-secondary vocational institutions also qualify if they are eligible to participate in Department of Education student aid programs.

Coverdell Education Savings Account

Although originally referred to as an Education IRA, the Coverdell Education Savings Account is really a nondeductible education savings account. The investment earnings from this account accrue and are withdrawn tax-free. The proceeds are used to pay qualified education expenses of the account beneficiary.

These accounts first became available in 1998, and non-deductible contributions of up to $500 were permitted per year for the benefit of the designated beneficiary. Beginning in 2002, the allowable nondeductible contribution has been increased to $2,000 per year per beneficiary. Contributions are only allowed for designated beneficiaries under the age of 18.

The annual contribution limit is gradually reduced if the contributing taxpayer's "modified AGI" is within the phase-out range and eliminated for taxpayers above the range. Since 2002, the phase-out range for married taxpayers filing jointly has been $190,000 - $220,000 and $95,000 – $110,000 for single taxpayers. These phase-out ranges are subject to change; please call this office to verify the current phase-out levels.

Anyone is allowed to make the contribution provided the total contribution for the under 18 beneficiary does not exceed the annual contribution limit and the contributing taxpayer's AGI is within limits. If the AGI limits the contribution, the funds can be gifted to someone else whose contribution would not be AGI limited, even the beneficiary.

Distributions from the Coverdell Education Savings Account are tax-and penalty-free (including interest on the account) if they are used to pay for qualified education expenses of the designated beneficiary or a member of the beneficiary's family.

The definition of qualified education expenses includes elementary or secondary education, kindergarten through grade 12.

Because of the phase-out provision for contributions, taxpayers cannot always be sure they can contribute to the accounts. Recognizing this problem, the tax law permits Coverdell contributions to be made after the close of the tax year for which the contribution is being made and before the April 15 filing due date for that year. (Note: if the April 15 due date falls on a Saturday, Sunday or holiday, the due date is the next business day.)

Additional rules apply for dealing with rollovers, changes in designated beneficiaries, death of taxpayer or beneficiary, excess contributions, special needs beneficiaries, and unauthorized use of distributions.

Qualified State Tuition Programs

A qualified state tuition program is one generally set up by a state or state instrumentality that lets individuals make contributions to an account established for a designated beneficiary's higher education.

Unlike the Coverdell Education Savings Account, there is no limit on the annual contributions to Qualified State Tuition programs. However, contributions to these plans are considered gifts to the beneficiary, making the annual gift exclusion amount the practical annual limit per contributor. The long-standing annual gift exclusion amount of $10,000 is now inflation-adjusted ($13,000 for 2009); please call this office for the limit for other years. A special rule allows a donor who makes total contributions exceeding the annual gift limit to elect to take the contributions into account ratably over a five-year period, starting with the year of the contribution. This allows a donor to contribute as much as $50,000 adjusted for inflation (75,000 for 2009) in one year, while avoiding the gift tax implications. The donor must file a gift tax return for the year of the contribution, and a five-year election must be made on the return. Care should be exercised in determining the total contributed to any individual's account to avoid nonqualified distributions if the amount exceeds the educational needs.

Virtually all of the high population states now have these programs, which are professionally managed and tailor the investments and risk potential to the potential student's current age. Individuals are not restricted to using the program established in their home state but instead can pick and choose among the programs of any of the states that have established programs.

The benefit of these programs was significantly enhanced a few years back when the distributions of earnings from the programs can be excluded from income if used for qualified expenses. This is a big change from prior rules where the earnings from the accounts were taxable to the beneficiary when withdrawn. This puts the Qualified State Tuition Programs on par with Coverdell Education Savings Accounts, but without the annual contribution limit. Additional rules apply for designated beneficiaries, death of taxpayer or beneficiary, and unauthorized use of distributions.

Penalty-Free IRA Withdrawals

Generally, when funds are withdrawn from an IRA before a taxpayer reaches age $59\frac{1}{2}$, a 10% early withdrawal penalty applies to the distribution. However, penalty-free IRA withdrawals are permitted if the funds are used to pay qualified higher education expenses. The withdrawals will still be subject to regular income tax.

Qualified "higher education expenses" include tuition at a qualified educational institution, as well as related room, board, fees, books, supplies, and equipment. The expenses can be for the taxpayer, his or her spouse, or taxpayer's or spouse's children and grandchildren.

Deduction For Interest

Generally, taxpayers can only deduct home mortgage interest, investment interest, and business interest. However, interest paid on student loans used to pay tuition, room and board, and related expenses for qualified higher education is deductible even if the taxpayer uses the standard deduction. The amount annually deductible is limited to $2,500. (This limitation has been in effect for several years but can change).