

Paying for College: **Tax Benefits and Savings Options**

An array of tax tools is available to help you meet the cost of higher education, including:

- tax credits—Hope and Lifetime Learning;
- above-the-line deduction for higher education expenses;
- deduction of student loan interest;
- tax-free withdrawals from education savings accounts (ESAs);
- tax-free withdrawals from state-sponsored and private tuition savings plans; and
- tax-free, employer-provided tuition benefits.

Each option is unique, with its own rules and limitations on eligibility and income. This paper provides an overview of the tax benefits that you may be eligible to use to assist you in fulfilling your educational objectives.

Tax Credits and Deductions

You can claim tax credits or, in some cases, deductions, for expenses that you pay for postsecondary education for yourself, your spouse, or your dependent children. The Hope tax credit is available on a per-student basis for the first two years of postsecondary education, whereas the Lifetime Learning credit is available on a tax-return basis and covers a broader time frame and range of educational courses. An “above-the-line” deduction, provides some relief to families whose income is too high to qualify for the Hope and Lifetime Learning tax credits. Education expenses paid for with tax-free grants, scholarships, and employer-provided tuition assistance are not eligible for the credits or for the above-the-line deduction. However, education expenses paid for with loans are eligible for these tax benefits.

Hope Credit

A tax credit equal to all of the first \$1,100 of tuition and fees (less scholarships, grants, and tax-free tuition benefits) and half of the next \$1,100 of tuition and fees, is available to parents of dependent students or to students who are not claimed as dependents on their parents’ tax return. Beginning in 2006, the maximum amount of the Hope credit is \$1,650 per student (\$3,300 for a Gulf Opportunity (GO) Zone student). The Hope credit can be claimed only for two tax years and applies only to the first two years of postsecondary education. Students must be enrolled at least half-time in a program that leads to a degree, certificate, or other educational credential during at least one academic period that begins during the tax year. Students cannot have had a drug felony conviction in a year in which the credit applies.

Lifetime Learning Credit

This credit applies to tuition and fees for undergraduate, graduate, and continuing education coursework to acquire or improve job skills. Parents of dependent students or students who are not claimed as dependents on their parents’ tax returns may claim a credit equal to 20% of up to \$10,000 of educational expenses; the maximum benefit is \$2,000 each tax year (\$4,000 for GO Zone students). Eligible education expenses are offset by scholarships, grants, and other tax-free tuition benefits.

Income Limitations on the Education Tax Credits

The full value of the education tax credits is available to married taxpayers filing jointly with an adjusted gross income (AGI) of \$110,000 or less and to single taxpayers with an AGI of \$55,000 or less.

Above-the-Line Deduction

If you cannot claim either the Hope or Lifetime Learning tax credit, you may still be able to deduct qualified higher education expenses from your taxable income. Self-supporting students, including those who borrow to pay tuition, are eligible to take this deduction. The deduction also provides relief to families whose AGI is too high to qualify for the Hope or Lifetime Learning tax credits. Single filers with AGI of up to \$65,000 (\$130,000 for joint filers) can deduct up to \$4,000 annually in tuition and related expenses.

Note: you do not need to itemize to claim the deduction.

Student Loan Interest Deduction

Student borrowers or their families can deduct student loan interest payments from their taxable income. The deduction is available even if you do not itemize other deductions. The loan does not have to be federally guaranteed or subsidized to be eligible for the deduction, but it must be used to pay education expenses such as tuition, fees, books, and room and board. The maximum deduction is \$2,500. The AGI limit for the full interest deduction is \$50,000 for single filers, phasing out at a maximum of \$65,000, and \$105,000 for joint filers, phasing out at \$135,000. Voluntary interest payments may be deducted.

Tax Incentives to Save for College

In recent years, tax-advantaged programs to help families save for college have become more flexible. Prepaid tuition plans allow families to buy units of tuition and guarantee that these units may be redeemed for a portion of tuition in future years. A number of states offer such plans, and private colleges may also set up prepaid tuition plans. Qualified state tuition savings programs provide for market-based investment accounts with tax-deferred earnings. Withdrawals from state college savings and prepaid programs, known as section 529 plans, to pay qualified higher education expenses will be free from federal (and, in many cases, state) income taxes. Withdrawals from Coverdell Education Savings Accounts (ESAs) may be used to cover qualified elementary and secondary expenses at public, private, and religious schools in addition to expenses for higher education.

Prepaid Tuition/Tuition Savings Plans

Distributions from state tuition savings programs and prepaid tuition plans are tax-free for federal income tax purposes, if withdrawals are used for qualified higher education expenses. Similar withdrawals from qualified prepaid tuition plans for private colleges are also tax-free. Accumulations may be rolled over, tax-free, from one 529 plan to another once every 12 months. You may not report payment of the same educational expenses from both 529 plans and ESAs. Likewise, the education expenses covered by Hope or Lifetime Learning credits do not qualify for tax-free distributions from 529 plans or ESAs. Nonqualified withdrawals from 529 plans will be subject to the same 10 percent tax penalty on deferred earnings that applies to ESAs, which is in addition to normal federal income taxes.

Coverdell Education Savings Accounts

You may invest up to \$2,000 annually on an after-tax basis per child in an ESA. Earnings accumulate tax-free, and money withdrawn to pay for qualified education expenses (tuition, fees, books, equipment, room and board) is free from income taxes. Withdrawals may be made for qualified expenses related to education from kindergarten through grade 12 and for undergraduate and graduate education. Contributions must stop when a child reaches age 18. Funds not used for education by the time the child reaches age 30 must be transferred to a younger beneficiary or must be withdrawn, and these funds will be subject to

tax on the earnings and a 10% penalty. Although more than one person may contribute to an ESA for the same child, no more than \$2,000 for that child can be contributed in any year. The AGI limit for married taxpayers is \$220,000 (\$110,000 for single taxpayers); taxpayers claiming an education tax credit can exclude from gross income an ESA distribution used for other qualified expenses; and contributions to both an ESA and a 529 plan are allowed.

Employer-Provided Tuition

You may exclude up to \$5,250 from your annual income when your employer helps you pay for higher education costs. This benefit covers employer-provided tuition assistance for both undergraduate and graduate level courses.

Information Is Important

Remember to save your records of all education-related payments and financial aid for tax purposes. Colleges and universities will need to collect Social Security numbers from all students so they can issue information reports to assist you in preparing your tax returns. Institutions are required to provide Form 1098-T, Tuition Payments Statement, to students from whom or on whose behalf they receive tuition payment (with the exception of continuing education students and nonresident alien students). Banks, institutions, and other lenders that collect student loan interest payments must issue annual information returns—Form 1098-E, Student Loan Interest Payments—to individuals from whom they collect more than

\$600 in interest during the tax year. Although you do not need to have or include a copy of these forms with your tax return to take advantage of the education credits or deductions, these records can assist you in determining your qualified education expenses for the year.

For more information: IRS Publication 970, Tax Benefits for Higher Education, and Publication 520, Scholarships and Fellowships, are available from the IRS Web site at www.irs.gov or by calling 1-800-TAX-FORM .

Academic Level for Tax Benefits

Tax Benefit	Types of Classes Eligible
Hope Credit	first two years of undergraduate (status as of January 1)
Lifetime Learning Credit	undergraduate, graduate, and individual job-related courses
Above-the-line Deduction	undergraduate, graduate, and individual courses
Student Loan Interest Deduction	undergraduate, graduate
Withdrawals from Section 529 Plans	undergraduate, graduate
Withdrawals from ESAs	K-12, undergraduate, graduate
Employer-Provider Tuition	undergraduate, graduate