Higher Education Costs: How To Get The Best Tax Treatment

Various tax benefits - tax exemption, tax deferral, tax credits, and deductions - are available if you are paying or saving for college or other higher education costs. This Guide suggests ways to take advantage of these benefits.

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Many tax benefits are available to help you pay higher education costs, whether for your children or yourself. Because of the variety of benefits and programs, this area is one of the most complex that an individual can face. This Financial Guide discusses strategies you can use to build savings for higher education, and tax credits currently available to help ease the financial burden of paying for education.

Eligibility rules vary for education credits and savings plans and most are subject to income limitations.

Coverdell Education Savings Accounts (Section 530 Programs)

You can contribute up to $2,000 in 2012 to a Coverdell Education Savings account (a Section 530 program formerly known as an Education IRA) for a child under 18. These contributions are not deductible, but they grow tax-free until withdrawn. Contributions for any year, for example 2011 can be made through the (unextended) due date for the return for that year (April 17, 2012).

Note: There is no adjustment for inflation, therefore the $2,000 contribution limit is expected to remain at $2,000 for 2012 and beyond.

Only cash can be contributed to a Section 530 account and you cannot contribute to the account after the child reaches his or her 18th birthday.

Anyone can establish and contribute to a Section 530 account, including the child. You may establish 530s for as many children as you wish, but the amount contributed during the year to each account cannot exceed $2,000. The child need not be a dependent, and in fact does not even need to be related to you. The maximum contribution amount for each child is subject to a phase out limitation with a modified AGI between $190,000 and $220,000 for joint filers and $95,000 and $110,000 for single filers.

Note: A 6% excise tax (to be paid by the beneficiary) applies to excess contributions. These are amounts in excess of the applicable contribution limit ($2,000 or phase out amount) and contributions for a year that amounts are contributed to a qualified tuition program for the same child. A qualified tuition program (QTP), sometimes called a Section 529 program, is a tax-favored state program to prepay education costs (see below). The 6% tax continues for each year the excess contribution stays in the 530 account.

The child must be named (designated as beneficiary) in the Coverdell document, but the beneficiary can be changed to another family member (for example, to a sibling where the first beneficiary gets a scholarship or drops out). And funds can be rolled over tax-free from one child's account to another's. Funds must be distributed not later than 30 days after the beneficiary's 30th birthday (or 20 days after the beneficiary's death if earlier). For "special needs" beneficiaries the age limits (no contributions after age 18, distribution by age 30) don't apply.

Withdrawals are taxable to the person who gets the money, with these major exceptions: Only the earnings portion is taxable (the contributions come back tax-free). Also, even that part isn't taxable income, as long as the amount withdrawn doesn't exceed a child's "qualified higher education expenses" for that year. The definition of "qualified higher education expenses" includes room and board and books, as well as tuition. In figuring whether withdrawals exceed qualified expenses, expenses are reduced by certain scholarships and by amounts for which tax credits (see Educational Credits, below) are allowed. If the amount withdrawn for the year exceeds the education expenses for the year, the excess is partly taxable under a complex formula. There's another formula if the sum of withdrawals from this 530 program and from the qualified tuition (Section 529) program exceed education expenses.

As the person who sets up the Section 530 account, you may change the beneficiary (the child who will get the funds) or roll the funds over to the account of a new beneficiary, tax-free, if the new beneficiary is a member of your family. But funds you take back (for example, withdrawal in a year when there are no qualified higher education expenses, because the child is not enrolled in higher education) are taxable to you, to the extent of earnings on your contributions, and you will generally have to pay an additional 10% tax on the taxable amount. However, you won't owe tax on earnings on amounts contributed that are returned to you by June 1 of the year following contribution.

Investment policy

In contrast to Section 529 programs and Series EE bonds, you are able to choose and change Section 530 investments as you see fit.

Tip: Check with your financial adviser about using both the Section 530 program, which has wide investment options but limited ($2,000 or less) contribution/investment amounts, and the Section 529 program, which has limited investment options but allows higher contribution/investment amounts.

Elementary and secondary schools

Section 530 programs can be used to build up funds for primary and secondary education. The tax rules are similar to those for higher education: withdrawals taxable to the extent of earnings on contributions, except tax-free up to the child's qualified elementary and secondary education expenses. These expenses qualify whether the child attends a private, religious or public school. Expenses such as room, board, tuition, transportation and uniforms will qualify only where connected with private or religious schools, but some expenses - books, computers, educational software and internet access - apply as well to children in public school living at home.

The age limits for higher education apply here too: no contribution after child reaches age 18, distribution at age 30 except for special needs beneficiaries. Withdrawals in excess of qualified education expenses are taxable under a special formula.

Qualified Tuition Programs (Section 529 Programs)

Every state now has a program allowing persons to prepay for future higher education, with tax relief. There are two basic plan types, with many variations among them:

1. The prepaid education arrangement. Here one is essentially buying future education at today's costs, by buying education credits or certificates. This is the older type of program, and tends to limit the student's choice to schools within the state. Private colleges and universities may now offer this type.
2. Education savings accounts. Here, contributions are made to an account to be used for future higher education.

In approaching state programs one must distinguish between what the federal tax law allows and what an individual state's program may impose.

You may open a Section 529 program in any state, but when buying prepaid tuition credits (less popular than savings accounts), you will want to know to what institutions the credits will be applied.

Unlike certain other tax-favored higher education programs, such as the American Opportunity Tax Credit (formerly the Hope Credit) and lifetime learning tax credits, federal tax law doesn't limit the benefit to tuition, but can also extend it to room, board, and books (individual state programs could be narrower).

The two key individual parties to the program are the Designated Beneficiary (the student-to-be) and the Account Owner, who is entitled to choose and change the beneficiary and who is normally the principal contributor to the program. There are no income limits on who may be an account owner. There's only one designated beneficiary per account. Thus, a parent with three college-bound children might set up 3 accounts. (Some state programs don't allow the same person to be both beneficiary and account owner.)

Contributions must be in cash, and must not total more than reasonably needed for higher education (as determined initially by the state). Neither account owner nor beneficiary may direct investments, but the state may allow the owner to select a type of investment fund (e.g., fixed income securities), and to change the investment annually, and when the beneficiary is changed. The account owner decides who gets the funds (can pick and change the beneficiary) and is legally allowed to withdraw funds at any time, subject to tax and penalty discussed later.

Funds in the account not yet distributed at the account owner's death pass as part of the probate estate under state law-though this is not the result for federal estate tax purposes, see below.

Federal Tax Rules

Income tax. Contributions made by the account owner or other contributor are not deductible for federal income tax purposes. Earnings on contributions grow tax-free while in the program.

Distributions from the fund are tax-free to the extent used for qualified higher education expenses. Distributions used otherwise are taxable to the extent of the portion which represents earnings.

A Section 529 distribution can be tax-free even though the student is claiming an American Opportunity Tax Credit (formerly the Hope Credit) or lifetime learning credit, or tax-free treatment for a Section 530 Coverdell distribution, if the programs aren't covering the same specific expenses.

Distribution for a purpose other than qualified education is taxed to the one getting the distribution. In addition, a 10% penalty must be imposed on the taxable portion of the distribution, comparable to the 10% penalty in Section 530 Coverdell plans.

The account owner may change beneficiary designation from one to another in the same family. Funds in the account roll over tax-free for the benefit of the new beneficiary.

Gift Tax. For gift tax purposes, contributions are treated as completed gifts even though the account owner has the right to withdraw them. Thus they qualify for the up-to-$13,000 annual gift tax exclusion in 2012 (no change from 2011). One contributing more than $13,000 may elect to treat the gift as made in equal installments over the year of gift and the following 4 years, so that up to $65,000 can be given tax-free in the first year.

A rollover from one beneficiary to another in a younger generation is treated as a gift from the first beneficiary, an odd result for an act the "giver" may have had nothing to do with.

Estate tax. Funds in the account at the designated beneficiary's death are included in the beneficiary's estate, another odd result, since those funds may not be available to pay the tax. Funds in the account at the account owner's death are not included in the owner's estate, except for a portion thereof where the gift tax exclusion installment election is made for gifts over $13,000. For example, if the account owner made the election for a gift of $65,000 in 2011, a part of that gift is included in the estate if he or she dies within 5 years.

Tip: A Section 529 program can be an especially attractive estate-planning move for grandparents. There are no income limits, the account owner giving up to $65,000 avoids gift tax, and estate tax by living 5 years after the gift, yet has the power to change the beneficiary.

State Tax: State tax rules are all over the map. Some reflect the federal rules, some quite different rules. For specifics of each state's program, see College Savings Plans Network (CSPN).

Professional guidance: Considering the wide differences among state plans, the federal and state tax issues, and the dollar amounts at stake, professional tax guidance is advised.

Traditional and Roth IRAs

You can use a traditional IRA or Roth IRA as a savings plan to pay qualified higher education expenses. Withdrawals before age 59 1/2 to pay qualified higher education expenses are not subject to the additional tax on early withdrawals. To escape the 10% tax however, you must pay education costs that at least equal your withdrawal amount. The education costs must be "qualified", that is, used for tuition, fees, books, room and board, supplies, or equipment at a qualified institution of learning and they must be for yourself, your spouse, or the children or grandchildren or yourself or your spouse. The qualified institution of learning may be any college, university, vocational school, or other post-secondary school that is eligible to participate in federal Department of Education aid programs.

Tip: You do not actually have to use the IRA funds to pay education costs. That is, the tax relief doesn't require you to trace the IRA withdrawal dollars to a specific education expense payment. You can pay the costs with your own earnings or savings, with a loan, or with a gift or inheritance received by the student or the person making the withdrawal. You can use savings accumulated in a Section 529 (state sponsored) program.

However, you cannot count education costs paid with proceeds from the following in determining whether your IRA withdrawal is to be free of the 10% tax:

- Tax-free distributions from a Coverdell education savings account (Section 530 program);
- Tax-free scholarships, such as a Pell grant;
- Tax-free employer education assistance program;
- Any tax-free payment (other than a gift or bequest) that is due to enrollment at the qualified institution.

Education Savings Bonds

You can exclude from your gross income interest on qualified U.S. savings bonds if you have qualified higher education expenses during the year in which you redeem the bonds. The exclusion phases out where the bondholder has (modified) adjusted gross income (MAGI) over a specified amount in the year the bond is redeemed. The amount, indexed for inflation, is $71,100 (single) in 2011 and $106,650 (joint). The exclusion is unavailable to married filing separately. Further, it should be noted that the exclusion is not allowed for MAGI of $86,100 or more for single filers and $136,650 or more for joint filers.

The education must be of the bondholder, his or her spouse or dependent. Qualified higher education expenses are tuition and fees, and contributions to Section 529 and 530 programs, reduced for tax-free scholarships and other relief.

A qualified U.S. savings bond means a Series EE bond issued after 1989. The bond must be either in your name or in the names of both you and your spouse, and you must be at least 24 years old before the bond's issue date.

Education Credits

Two tax credits are available for education costs - the American Opportunity Credit (modified Hope Credit) and the lifetime-learning credit. These credits are available only to taxpayers with adjusted gross income below specified amounts (see Income Phase-Outs below).

How These Credits Work

The amount of the credit you can claim depends on (1) how much you pay for qualified tuition and other expenses for students and (2) your adjusted gross income (AGI) for the year.

You must report the eligible student's name and Social Security number on your return to claim the credit. You subtract the credits from your federal income tax. If the credit reduces your tax below zero, you cannot receive the excess as a refund. If you receive a refund of education costs for which you claimed a credit in a later year, you may have to repay ("recapture") the credit.

Caution: If you file married-filing separately, you cannot claim these credits.

Which costs are eligible. Qualifying tuition and related expenses refers to tuition and fees, and course materials required for enrollment or attendance at an eligible education institution. They now include books, supplies and equipment needed for a course of study whether or not the materials must be purchased from the educational institution as a condition of enrollment or attendance.

"Related" expenses do not include room and board, student activities, athletics (other than courses that are part of a degree program), insurance, equipment, transportation, or any personal, living, or family expenses. Student-activity fees are included in qualified education expenses only if the fees must be paid to the institution as a condition of enrollment or attendance. For expenses paid with borrowed funds, count the expenses when they are paid, not when borrowings are repaid.

Tip: If you pay qualified expenses for a school semester that begins in the first three months of the following year, you can use the prepaid amount in figuring your credit.

Example: You pay $1,500 of tuition in December 2009 for the winter 2010 semester, which begins in January 2010. You can use the $1,500 in figuring your 2009 credit. If you paid in January instead, you would take the credit on your 2010 return.

Tip: As future year-end tax planning, this rule gives you a choice of the year to take the credit for academic periods beginning in the first 3 months of the year; pay by December and take the credit this year; pay in January or later and take the credit next year.

Eligible students. You, your spouse, or an eligible dependent (someone for whom you can claim a dependency exemption, including children under age 24 who are full-time students) can be an eligible student for whom the credit can apply. If you claim the student as a dependent, qualifying expenses paid by the student are treated as paid by you, and for your credit purposes are added to expenses you paid. A person claimed as another person's dependent can't claim the credit. The student must be enrolled at an eligible education institution (any accredited public, non-profit, or private post-secondary institution eligible to participate in student Department of Education aid programs) for at least one academic period (semester, trimester, etc.) during the year.

No "double-dipping." The tax law says that you can't claim both a credit and a deduction for the same higher education costs. It also says that if you pay education costs with a tax-free scholarship, Pell grant, or employer-provided educational assistance, you cannot claim a credit for those amounts.

Income Limits. To claim the American Opportunity Credit your modified adjusted gross income (MAGI) must not exceed $90,000 ($180,000 for joint filers). To claim the Lifetime Learning Credit, MAGI must not exceed $60,000 ($120,000 for joint filers). "Modified AGI" generally means your adjusted gross income. The "modifications" only come into play if you have income earned abroad.

The American Opportunity Tax Credit

The new education credit called the American Opportunity Tax Credit (AOC) was extended for 2011 and 2012. This is a modification of the Hope Credit. The maximum credit, available only for the first four years of post-secondary education, is $2,500 in 2012 (and 2011). You can claim the credit for each eligible student you have for which the credit requirements are met.

Special Qualification Rules. In addition to being an eligible student, he or she:

- Must be enrolled in a program leading to a degree, certificate, or other recognized credential;
- Must be taking at least half of a normal full-time load of courses, for at least one semester or trimester beginning in the year for which the credit is claimed; and
- May not have any drug-related felony convictions.

Amount of credit. The maximum amount of the AOC credit is $2,500. Generally, 40% of the AOC is now a refundable credit for most taxpayers, which means that you can receive up to $1,000 even if you owe no taxes.

The Lifetime Learning Credit

You may be able to claim a Lifetime Learning credit of up to $2,000 (20% of the first $10,000 of qualified expense) for eligible students (subject to reduction based on your AGI). Only one Lifetime Learning Credit can be taken per tax return, regardless of the number of students in the family.

- The credit can help pay for undergraduate, graduate and professional degree courses, including courses to improve job skills.
- For courses taken to acquire or improve job skills, there are no requirements as to course loads, so that even one or two courses can qualify.
- The number of years for which this credit can be claimed is not limited.

Choosing the Credit. You can't claim both credits for the same person in the same year. But you can claim one credit for one or more family members and the other credit for expenses for one or more others in the same year - for example, an AOC for your child and a lifetime learning credit for yourself.

Electing Not To Take the Credit. There are situations in which the credit is not allowed, or not fully available, if some other education tax benefit is claimed - where the higher education expense deduction is claimed for the same student, see below, or where credit and tax exemption (under a Section 529 or 530 program) are claimed for the same expense. In that case the taxpayer - or, more likely, the taxpayer's tax adviser - will determine which tax rule offers the greater benefit and if it's not the credit, elect not to take the credit.

Qualified Tuition and Related Expenses Deduction

A limited deduction is allowed for "qualified higher education expenses" -- tuition and related expenses under the same definition as for tuition credits, above. A $4,000 above the line deduction (Form 8917) is allowed for qualified tuition expenses in 2012. Deduction up to $4,000 is allowed on if taxpayer's (modified) adjusted gross income is $65,000 or less ($130,000 or less on a joint return). If taxpayer's modified adjusted gross income is more than $65,000 but not more than $80,000 (more than $130,000 but not more than $160,000 on a joint return), deduction is allowed up to $2,000. The tax deduction reduces your amount of income, reducing amount of tax you pay. You do not need to itemize deductions on Schedule A (Form 1040) in order to take this deduction, which benefits higher earners who cannot take the Lifetime Learning Credit because their income exceeds the limits.

Business expense deduction is allowed, without dollar limit, for education that serves the taxpayer's business, including employment. Deduction is also allowed for student loan interest, but a taxpayer may not take more than one deduction for the same item. In addition, you cannot claim this deduction if your filing status is married filing separately or if another person can claim an exemption for you as a dependent on his or her tax return.

"Qualified higher education expenses" must be reduced by any such expense paid with an amount treated as tax-free under the rules for excluding income from Series EE bonds, or Section 529 or 530 programs.

Employer-Provided Education Assistance

If your employer paid education assistance benefits (e.g., reimbursements of tuition), part or all of them may be tax-free. You can exclude up to $5,250 per year of the benefits you receive under a qualified educational assistance program. But you can't both exclude and deduct the same item, even if it's otherwise deductible. In order to qualify, your employer must have established an educational assistance plan that does not discriminate in favor of highly paid employees or owners. The exclusion applies to undergraduate level courses other than those involving sports, game and hobbies. The courses do not need to relate to your job. The exclusion is available for tuition, fees, books and supplies but not meals, lodging or transportation. And it applies to benefits for graduate level courses.

In addition to the exclusion for qualifying education plans, your employer can provide reimbursement for business related courses, including graduate courses. If your employer does not reimburse you for these expenses, you may be entitled to deduct them as a miscellaneous itemized deduction subject to the 2% deduction floor. To qualify, the expense must meet the requirement of your employer or the law or maintain or improve skills in your current job. The course must not meet minimum education requirements for your job or qualify you for a new trade or business.

Student Loans

You may be able to deduct interest on student loans. You may also be able to exclude income that you would otherwise have to report if a student loan is cancelled.

Interest Deduction. You may deduct student loan interest you pay, including interest paid that's not currently due because payment is deferred.

Deduction is allowed even though it would otherwise be nondeductible personal interest. But you may deduct only if you are the one legally bound to pay the interest, and only on loans solely for qualified expenses (so not under open credit lines).

The student-loan deduction up to $2,500 is available in 2012, but only to taxpayers whose AGI is below $150,000 (joint filers) or $75,000 (single filers). Married couples filing separately can't take the deduction.

The student-loan interest deduction is an "above the line" deduction. In other words, you don't have to itemize in order to claim it. The loan must have been taken out to cover education expenses of at least half-time study for yourself, your spouse, or a person who was your dependent when you took out the loan.

Caution: You cannot deduct interest on a loan from a related person, for example, a relative, or a business entity in which you have an ownership interest as defined by the tax law. And you can't deduct if you are claimed as a dependent.

Tip: Where interest fails to qualify under these tests, consider a home equity loan, interest on which is generally deductible.

Cancellation of Student Loan. If certain requirements are met, cancellations of student loans that are intended to induce students to perform certain services do not increase the student's gross income. This relief extends to certain private programs, as well as government and public programs.