

EDUCATIONAL TAX INCENTIVES

Educational Tax Incentives – Phase-outs & Offsets					
Incentive	Limit	Tax Nature	Covers	AGI Phase-out	Offsets
Life Insurance, cash value	None	Premium not deductible; policy withdrawal/loans tax-free.	Unlimited, no restrictions.	None	n/a
American Opportunity Credit	2,500	Credit against taxes.	First four years of post-secondary education.	S:80,000-90,000 J:160,000-180,000	ABCD
Lifetime Learning Credit	2,000	Credit against taxes.	Unlimited number of years.	S:50,000-60,000 J:100,000-120,000	ABCD
Trade or Business Expense	None	Below-line deduction (must itemize)	Employee expenses in maintaining or improving skills.	None in 2010.	n/a
Education Expenses	4,000/2,000	Above-line deduction (need not itemize).	Qualified educational expenses paid.	S:65,000-80,000 J:130,000-160,000	A
Employer Tuition Reimbursement	5,250	Not included in income.	Covers both undergraduate and graduate programs.	None.	B
Coverdell Education Savings Account	2,000	Contributions not deductible, but earnings are tax-free.	Qualified education expenses paid.	S:95,000-110,000 J:190,000-220,000	C
Student Loans	2,500	Above-line deduction for interest (need not itemize).	Student loan interest.	S:60,000-75,000 J:120,000-150,000	n/a
Section 529 Plans	Varies.	Contributions not deductible, but earnings are tax-free.	Tuition, fees, special-needs services, room, board, books, supplies, equipment, and computer technology.	None.	D
Educational Savings Bonds	Varies.	Interest tax-free.	Qualified educational expenses.	S:70,100-85,100 J:105,100-135,100	n/a

Under column "AGI Phase-out," "S" indicates single taxpayer and "J" married filing joint return.



A – American Opportunity Credit is a modification of the Hope Scholarship Credit for tax years 2009 and 2010.
B – American Opportunity Credits and Lifetime Learning Credits are not available for the same expense excluded as an Employer Tuition Reimbursement.
C – Earnings on Coverdell Education Savings Account are not tax-free if used for same expenses as American Opportunity Credit and Lifetime Learning Credits.
D – Section 529 qualifying expenses are reduced to the extent they are used in determining American Opportunity Credit and Lifetime Learning Credits.

There is an array of tax-related education incentives available. Some require advance planning in order to establish the savings mechanism providing the tax incentive. Others require no advanced planning – it is a matter of determining which should be claimed at the time education expenses are incurred (assuming they are still available when a child goes to college). However, it is very important to prioritize these incentives, since many of them are mutually exclusive.

No advanced planning is required for the following (just hope the law does not change):

1. **American Opportunity Credit** offers a \$2,500 income tax credit for the first four years of post-secondary education.
2. **Lifetime Learning Credit** offers a \$2,000 income tax credit for post-secondary education and is not limited to the first two years.
3. **Student loan interest deduction** provides an above-the-line \$2,500 deduction.

Advanced planning is generally required to take advantage of:

1. **Life Insurance** to provide cash accumulation value to access withdrawal/loans tax-free. Withdrawal/loan amount are not restricted for use; no requirement that funds be used for education. And, under current guidelines, life insurance cash value is not considered for federal financial aid or education assistance.

Premiums paid can vary and will depend on the amount of coverage purchased, age and health of insured.
2. **Coverdell Education Savings Accounts** allow income tax-free distribution of earnings to pay a beneficiary's qualified education expenses. (However, contributions are not deductible and are limited to \$2,000 per year.)
3. **Section 529 plans** provide an opportunity for tax-free distributions for qualified higher education expenses.
4. **Educational savings bonds** interest is tax-free if used for tuition and fees.

Employment related incentives depend upon the student's employment at the time of the education expense:

1. **Employer tuition reimbursement** is excludable from income up to \$5,250 per year.



2. **Trade or business expense** is a below-the-line deduction for employee educational expenses for maintaining or improving skills.

American Opportunity Credit:

This new credit, introduced by the American Recovery and Reinvestment Act of 2009, modifies and expands the Hope Scholarship tax credit for the years 2009 and 2010. During these two years it provides an income tax credit of up to \$2,500 per year for each of the first four years of college, calculated as 100% of the first \$2,000 of "qualified tuition and related expenses" and 25% of the next \$2,000. Books and course materials are included among eligible expenses. Qualified tuition and related expenses *do not* include nonacademic fees such as room and board, medical expenses, transportation, student activity fees, athletic fees, insurance expenses, personal, living, family or other unrelated expenses. The student must be enrolled at least half-time in a qualifying educational institution. However, the credit may not be taken if the student has ever been convicted of a state or federal charge of felony drug possession or distribution. The student may be the taxpayer, his or her spouse or any dependent. However, an individual who is eligible to be claimed as a dependent on another taxpayer's return may not take the credit. There is no limit in any given year as to the number of American Opportunity Credits a taxpayer may claim as to his or her dependents (i.e., the limit is on a *per-student* basis, and multiple American Opportunity Credits may be claimed in the same year). In 2010, the credit is phased out ratably between modified adjusted gross income of \$80,000 to \$90,000 for unmarried taxpayers and \$160,000 to \$180,000 for married taxpayers filing joint returns.

Lifetime Learning Credit:

The Lifetime Learning Credit is 20% of the first \$10,000 of qualified tuition and related expenses, for a maximum credit of \$2,000 per year ($.20 \times 10,000 = 2,000$). "Qualified tuition and related expenses" are the same as under the American Opportunity Credit (except that here these do not include required course materials for 2009 and 2010). However, in contrast to the American Opportunity Credit, which is on a per-student basis, the Lifetime Learning Credit limit is on a *per-taxpayer* basis, meaning that only \$10,000 of educational expenses qualifies per year. In 2010 the credit is phased out ratably between modified adjusted gross income of \$50,000 to \$60,000 for unmarried taxpayers and \$100,000 to \$120,000 for married taxpayers filing joint returns. Also, unlike the American Opportunity Credit, the Lifetime Learning Credit can be taken for any year of post-secondary education (except a year in which the American Opportunity Credit is claimed for the same student), does not require at least half-time enrollment, and study may be intended to improve the student's job skills and need not lead to a degree.

Student Loan Interest Deduction:

This maximum \$2,500 deduction is an "above the line" deduction, meaning that the taxpayer does not have to itemize in order to claim the deduction. In 2010 the deduction is phased out ratably for unmarried taxpayers with modified adjusted gross income of \$60,000 to \$75,000, and \$120,000 to \$150,000 for married taxpayers filing joint returns (these threshold limits are adjusted for inflation).

Coverdell Education Savings Account:

A Coverdell Education Savings Account (originally called an "Education IRA"), may be created for the purpose of paying the qualified education expenses of a designated beneficiary.

1. **Contributions:** Annual contributions are limited to \$2,000 per beneficiary per year, and the beneficiary must be under age 18 (except in the case of a special needs beneficiary). This \$2,000 annual contribution limit is phased out ratably for individual taxpayers with modified AGI between



\$95,000 and \$110,000, and for married taxpayers filing jointly with modified AGI between \$190,000 and \$220,000. Contributors with modified AGI above these phase-out ranges are not allowed to make contributions. This contribution limit is per beneficiary; meaning that multiple contributors cannot exceed the \$2,000 *per beneficiary per year* limit (e.g., if grandfather contributes \$1,800 for grandson then grandmother is limited to contributing an additional \$200 for grandson).

2. **Taxation:** Contributions to an Education Savings Account are not income tax deductible, but earnings grow income tax-free. Contributions are treated as completed present interest gifts from the contributor to the beneficiary at the time of the contribution.
3. **Distributions:** When the funds are distributed to pay the beneficiary's qualified education expenses, *neither the principal nor the earnings will be included in the beneficiary's income*. Qualified education expenses include elementary and secondary school tuition, expenses of special needs beneficiaries, post-secondary tuition, fees, books, supplies, uniforms, equipment, and certain room and board expenses. The earnings portion of distributions that are not used to pay for qualified education expenses is not only taxed to the beneficiary, but is also subject to an additional 10-percent-penalty tax. For this purpose, the "earnings portion" means any growth in the funds in excess of the nondeductible contributions.
4. **Other Credits:** A taxpayer may claim an American Opportunity Credit or Lifetime Learning Credit for the same taxable year there are distributions from an Education Savings Account, provided the distributions are used to pay for different education costs.
5. **Balance Not Distributed:** Any balance remaining in an Education Savings Account at the time a beneficiary becomes 30 years old (except in the case of a special needs beneficiary) or dies, if earlier, must be distributed. The earnings portion of such a distribution will be includable in gross income of the beneficiary and subject to an additional 10% penalty tax because the distribution was not for educational purposes. However, it is possible to avoid taxation by rolling the account balance over to another Education Savings Account benefiting a different beneficiary, who is a member of the family of the original beneficiary and who has not attained age 30 as of such date (the under-age-30 requirement does not apply to a special needs beneficiary).

Section 529 Plans:

Also called qualified tuition programs (QTPs), these are state-sponsored or privately sponsored programs that are authorized by federal law.

1. **Prepaid educational arrangements** (PEAs) allow the taxpayer to purchase tuition credits or certificates on behalf of a designated beneficiary. These have also been known as "prepaid tuition plans." Private colleges and universities may establish PEAs.
2. **Educational savings accounts** (ESAs) allow the taxpayer to make contributions funding the "qualified higher education expenses" (QHEEs) of a designated beneficiary. QHEEs include tuition, fees, special-needs services, room and board, and the costs of books, supplies, and equipment (including computer technology for 2009 and 2010), required by a designated beneficiary at an eligible educational institution (post secondary education to include graduate school). Private colleges and universities *may not* establish ESAs.

There is a large difference among individual programs, many of which are more restrictive than required by Section 529. Before selecting a plan, it would be well advised to carefully review the individual account agreement.

Federal law generally does not place any limits on who may participate as an account owner, contributor, or designated beneficiary (except that the beneficiary must be an individual). In order to avoid excess



contributions, they are typically limited to the amount necessary to provide five years of education at more expensive schools (e.g., some programs allow for contributions of up to \$250,000).

Contributions must be in cash, are not tax deductible, and are treated as completed gifts eligible for the gift tax annual exclusion (\$13,000 in 2010). This gift tax treatment is unusual, given the owner's power to withdraw funds from the account subject to penalties and taxes or to designate a new beneficiary. Gifts in excess of the annual exclusion may be "front-loaded," meaning that a donor may avoid using his or her available unified credit by treating the gift as made over a period of 5 years (for a maximum of \$65,000 per spouse, or \$130,000 per couple, to each designated beneficiary). However, if the donor front loads an ESA and dies during the 5-year period, any front-loaded gifts allocable to the years after death are included in the donor's estate.

State-sponsored ESAs may permit the owner to choose among different investment strategies offered by the plan (1) when the account is opened, (2) once every 12 months, and (3) whenever the beneficiary designation is changed. Certain age-based plans automatically move to more conservative investments as the beneficiary ages. Separate accounting must be maintained for each designated beneficiary, with no pledging of the account assets by either the owner or the beneficiary. However, the account can be attached by the creditors of the owner, but not by the creditors of the beneficiary. In contrast, the value of the account is included in the estate of the designated beneficiary.

All account earnings are tax deferred. Distributions from state-sponsored QTPs and "private" PEAs that are used to pay QHEEs are excluded from gross income. Distributions not used for QHEEs are subject to a 10% penalty tax on the taxable portion of the distribution.

Education Savings Bonds:

The purchase of Series EE or Series I bonds can provide tax-free interest if the proceeds are used for the tuition and fees of a dependent (but not for room, board, books, or other expenses). The bond must be purchased by the owner (after attaining age 24), who must be either the sole or joint owner with a spouse. All interest on the bonds is potentially excludable from income provided the total amount redeemed (i.e., principal plus interest) does not exceed the amount of the student's qualified educational expenses. For example, assume the redemption amount is \$15,000 (\$7,500 of principal and \$7,500 of interest), and qualified educational expenses are \$20,000. The entire \$7,500 of interest is excluded from income (but subject to a threshold phase-out based upon modified adjusted gross income). However, if the aggregate proceeds of the bond exceed the amount of expenses paid, the amount of excludable interest is reduced pro rata, based on the proportion of educational expenses to redemption amounts. For example, assume the redemption amount is again \$15,000 (\$7,500 of principal and \$7,500 of interest), but qualified educational expenses are only \$12,000. The ratio of expenses to the amount redeemed is 80% ($12,000 / 15,000 = .80$). The excludable interest is limited to \$6,000 ($.80 \times 7,500 = 6,000$). There is a phase-out of this interest exclusion once modified adjusted gross income exceeds a designated amount (i.e., in 2010 for single return filers the phase-out is between \$70,100 and \$85,100; and for joint tax return filers the phase-out is between \$105,100 and \$135,100).

Employer Tuition Reimbursement:

Also known as "educational assistance plans" or "Section 127 plans," under these nondiscriminatory programs an employee may exclude up to \$5,250 of employer-provided educational assistance each calendar year. Amounts over \$5,250 are included in income and subject to employment and income tax withholding (but expenses related to the employee's current job may be deductible; see below). The educational expenses



need not be job related or lead to a degree. Covered expenses include tuition, fees, books, and supplies. Expenses for both undergraduate and graduate level courses are covered.

Trade or Business Expense:

Reimbursements to an employee outside of an educational assistance plan are included in the employee's income and are:

1. **Deductible** if the education expense was incurred for maintaining or improving skills required in employment – but this is a below-the-line deduction, meaning that employee must itemize and the deduction is subject to a "2% floor" (i.e., is only useful to the extent that miscellaneous itemized deductions exceed 2% of adjusted gross income).
2. **Not deductible** if the education expense was incurred for meeting minimum requirements for employment or qualifying for a new trade or business.

IRA Withdrawals:

Using a traditional IRA or a Roth IRA for education expenses offers varied tax advantages.

1. **Penalty Tax.** There is no 10% penalty tax on a withdrawal from either a traditional IRA or a Roth IRA when the withdrawal is for the qualified higher education expenses of a taxpayer
2. **Regular Tax.** The traditional IRA and Roth IRA are both subject to regular income taxes on withdrawals used for education expenses. However, the Roth IRA owner can:
 - a. At any time (and for any reason) withdraw his or her original nondeductible plan contributions free of income taxes, and
 - b. Withdraw earnings free of income taxes provided the withdrawal occurs after age 59½ and the account has been open for at least five years.

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