Chapter 8: Education Provisions

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Corrections were made to this workbook through January of 2003. No subsequent modifications were made.

The Economic Growth and Tax Relief Reconciliation Act of 2001 included many taxpayer-friendly education provisions. These changes affect various deductions and credits resulting in tax savings for a wide range of taxpayers. These changes provide ample planning opportunities. This chapter discusses the primary education provisions of the Taxpayer Relief Act of 1997 and the changes made by the 2001 Act that affect 2002 tax returns.

QUALIFIED TUITION PROGRAMS — I.R.C. §529 PLANS

I.R.C. §529 plans have often been called the "401(k) of educational savings programs." There are many similarities between 401(k) and I.R.C. §529 investments. Significant tax deferral and exclusion features make I.R.C. §529 plans attractive.

The amount invested in I.R.C. §529 plans, which were introduced in 1997, has grown exponentially. It is estimated that total assets in I.R.C. §529 plans nearly quadrupled from $2.5 billion to $9.5 billion during 2001, and it may increase to more than $25 billion in 2002. All 50 states, plus the District of Columbia, have established I.R.C. §529 plans. Many are managed by brokerage firms (TIAA-CREF is the largest I.R.C. §529 provider). Since all of these plans are new, selecting the best one is a difficult choice for investors.

WHAT IS A QUALIFIED TUITION PROGRAM (QTP)?

A QTP allows a person to either:

- prepay a student's tuition, or
- establish an account to pay a student's future college expenses (a college savings plan).

Qualified college expenses include:

- tuition,
- fees,
- books,
- supplies,
- equipment, and
- room and board (for students enrolled at least half-time).

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An eligible educational institution is any college, university, vocational school, or other postsecondary educational institution eligible to participate in a student aid program administered by the Department of Education.

Contributions to a state I.R.C. §529 plan are **not** deductible for federal income tax purposes, but they **may** be deductible on state income tax returns. The **earnings** in the current year are **tax-deferred** and **distributions** used to pay qualified college expenses are **tax-exempt beginning in 2002**.

PREPAID TUITION PLANS

Prepaid tuition plans allow a parent or other relative to purchase tuition credits that prepay a child's future college tuition. For example, the **College Illinois** plan (*www.collegeillinois.com*), which began in 1998, offers a "window" in the fall and winter of each year when tuition credits can be purchased. The advantage of these plans is the avoidance of future increases in tuition costs.

Many states allow nonresidents to invest in their prepaid tuition plans. However, the **College Illinois** plan requires the potential investor to be an Illinois resident for 12 months prior to sending in an application. Some states allow a state income tax deduction for contributions to their plans, but Illinois does not. Illinois does exempt qualified withdrawals from an I.R.C. §529 plan (**College Illinois,** as well as other state plans) from its state income tax, but some states do not. **College Illinois** charges a $75 initial enrollment fee and $40 for subsequent applications (as of July 2002). The fees for other state plans vary.

College Illinois offers various types of prepaid contracts:

- Up to nine semesters at an Illinois public 4-year university
- Up to four semesters at a community college
- Up to four semesters at a community college and four semesters at a public university

These contracts can be purchased with a lump sum payment, installment payments, or a combination.

Qualified withdrawals from the **College Illinois** plan can be made only for tuition and mandatory fees. They cannot be used for books, supplies, equipment, or room and board. Other state plans may have different requirements.

Various states have different time and age limitations. The **College Illinois** plan provides that:

- the benefits must be used within a **10-year period,** beginning on the date of projected enrollment;
- the contract must be purchased **at least three years before** tuition and fees are paid.

The contracts purchased under **College Illinois** can be used for tuition and fees at schools in other states, but it will not result in a one-for-one semester match. The value of the **College Illinois** contract is equal to the average mean-weighted credit hour value of in-state costs. For example, if the average for full-time tuition and fees is $3,000 for a semester in 2002-03, one **College Illinois** contract can be redeemed for $3,000 at a private Illinois-based college or at an out-of-state institution. Therefore, the **College Illinois** plan is portable if the student decides to go to a school other than an Illinois public university. Some states offer a bonus if the contract is used in-state, but Illinois does not. Over 30 state plans allow their contracts to be used at out-of-state colleges.

Most states have minimum and/or maximum contribution rules. For the enrollment period that ended in March 2002, **College Illinois** had a **minimum** contribution of **$847**, which purchased a 1-semester community college contract for a child who was kindergarten age or younger. The **maximum** contribution in the 2001-02 enrollment period was **$25,087**, which purchased a 9-semester contract at a public university for a child in the ninth grade or above. The $25,087 could be paid in installments.

What are the advantages of a prepaid tuition contract plan?

In a prepaid tuition plan, future semesters of tuition and fees are purchased at today's prices. The investor is insulated against rising tuition charges. In effect, any increase in future tuition costs increases the value of the contract. Also, the value of the contract is guaranteed, regardless of future fluctuations in the stock market. In addition, some states provide various state income tax benefits.

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What are the disadvantages of a prepaid tuition contract plan?

The purchaser of a prepaid tuition plan does not benefit from a potentially rising stock market. A college savings I.R.C. §529 plan (discussed later) may return a higher (or lower) yield. Normally, less money can be contributed to a prepaid tuition plan. All of the states have differing rules and regulations, requirements, minimums, maximums, etc.

COLLEGE SAVINGS PLANS

A college savings plan under I.R.C. §529 allows the investor to make contributions to an account to pay for a student's future college expenses. Parents, grandparents, or any other person may set up a college savings plan for a student beneficiary. Because contribution limits are larger, these plans are more widely used than prepaid tuition plans. For illustration, the **Bright Start College Savings Program for the state of Illinois** (*www.brightstartsavings.com*), managed by Salomon Smith Barney, was started in 2000. There are substantial differences between this plan and the **College Illinois** prepaid tuition plan. The **Bright Start** program:

- is fully open to nonresidents,
- allows an unlimited state income tax deduction for contributions,
- is **not** guaranteed by the state,
- charges multiple fees including a possible one-time processing fee ($30 as of summer 2002) and an asset-based management fee (0.99% as of summer 2002). Some states also allow a load charge for the selling broker,
- allows qualified withdrawals to cover tuition and mandatory fees AND room and board, books, supplies, and equipment,
- requires no minimum period before qualified withdrawals may be taken,
- has no limits on age or account duration,
- allows minimum contributions of only $25,
- accepts contributions until all account balances for one beneficiary reach **$235,000,**
- has an open enrollment period, and
- allows online account access.

Other state plans vary. There are numerous types of college savings plans available.

College savings plans offer various investment alternatives. For example, the **Bright Start** program for Illinois offers 100% equity or 100% fixed income options. Typically, there will be a higher level of stock investments in earlier years (further away from initial enrollment) with a switch to more fixed-income funds as the child nears college age.

CHANGES TO I.R.C. §529 PLANS EFFECTIVE IN 2002

Qualified distributions are now tax-free. Under prior law, the earnings portion of distributions from an I.R.C. §529 plan used for qualified college expenses was **included** in the beneficiary's gross income. Distributions made **after 2001** are now **excluded** from income if they are used for qualified college expenses. If 2002 distributions exceed qualified expenses, excluded earnings are limited as explained in the following Example.

> **Example 1.** In 2002, Abe withdraws $15,000 from a college savings plan. $4,500 of the distribution consisted of earnings. The remaining $10,500 consisted of contributions to the plan made in earlier years by Abe's parents. Abe uses $10,000 for qualified college expenses at State U, and uses the other $5,000 to buy a used car. **Because only ²/₃ ($10,000 ÷ $15,000) of the distribution was used to pay qualified expenses, only ²/₃ of the earnings will be excluded from gross income. Therefore, $3,000 (²/₃) of earnings will be excluded, and the other $1,500 (¹/₃) will be taxable.** A 10% penalty of $150 will also be imposed on Abe.

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The amount of the distribution excluded from gross income is generally reduced by:

- qualified scholarships,
- excludable employer-provided educational assistance,
- qualified higher education expenses used in determining the Hope and Lifetime Learning credits, or
- any tax-exempt distribution amounts will reduce the income exclusion amounts for U.S. savings bond interest on Form 8815, and the deduction for student loan interest. If a taxpayer uses distributions from a I.R.C. §529 plan and from an education IRA in 2002 (a scenario that could not be done in years prior to 2002), and, if the sum of the two distributions **exceeds** the total of qualified college expenses, **the expenses must be prorated between the two distributions** using a reasonable method determined by the taxpayer.

Additional qualifying college expenses have been added. In addition to adding provisions for special-needs services (to be defined in regulations), the 2001 Act increased the amount of room and board expenses that will be considered qualified expenses. For 2001, a $2,500 limit was placed on off-campus room and board expenses. Beginning in 2002, that limit is changed to an allowance for reasonable expenses for students who live off-campus and not at home. The college will determine this revised 2002 amount.

Rollovers are permitted. Amounts in an I.R.C. §529 plan can now be rolled over tax-free to another I.R.C. §529 plan for the same beneficiary. **Only one transfer within any 12-month period for the same beneficiary is allowed.** Designated beneficiaries can be changed if the primary beneficiary does not use amounts in the qualified tuition program. This change must be completed within 60 days of the distribution and the new beneficiary must be a **family member** of the primary beneficiary from whose program the transfer is made. **Family members** include:

- the primary beneficiary's spouse,
- a son or daughter or a descendant of a son or daughter,
- a stepson or stepdaughter,
- a brother, sister, stepbrother, or stepsister,
- a father or mother or ancestor of either,
- a stepfather or stepmother,
- a son or daughter of a brother or sister (a niece or nephew),
- a brother or sister of father or mother (an uncle or aunt), or
- the spouse of any of the above individuals.

For purposes of rollovers and changes of designated beneficiaries, the definition of family members was expanded by the 2001 Act to include first cousins of the primary beneficiary starting in 2002.

Qualified tuition programs can now be offered by private educational institutions. Under prior law, only states could administer I.R.C. §529 plans. Beginning in 2002, contributions can be made to an I.R.C. §529 plans established and maintained by private colleges and universities. Any earnings distributed before **January 1, 2004** will be taxable, but on or after that date, any earnings distributed will be tax-free.

Coordination with Coverdell education IRAs. Beginning in 2002, taxpayers may now make contributions to an I.R.C. §529 plan and to an education IRA in the same year for the benefit of the same beneficiary. This was not permitted under prior law.

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TAXABILITY OF DISTRIBUTIONS

As mentioned earlier, the 2001 Act changed the rules governing distributions from an I.R.C. §529 plan. **Starting in 2002, the beneficiary can exempt from income any earnings distributed from an I.R.C. §529 plan if used for higher education.** Any in-kind distribution (such as a tuition waiver) is considered a distribution to the beneficiary. With the recent decline in the stock market, it is possible that an I.R.C. §529 plan account balance may be lower than the amount originally contributed. In this case, any distribution would be considered a tax-free return of investment. If there are earnings, the determination of the amount considered earnings and the amount considered a return of investment depends on whether the plan is a college savings plan or a prepaid tuition plan.

College Savings Plan Distribution Rules for 2002

For a 2002 distribution from a college savings plan, **the part that is considered earnings** is determined by dividing the amount of the distribution by the account balance as of the end of the year (including all amounts distributed during the year), and multiplying this result by the earnings in the account as of the end of the year (including all earnings distributed during the year).

Example 2. Billy's parents opened an I.R.C. §529 college savings plan account on his behalf. They contributed a total of $18,000 to the account. By the end of 2002, there was a total of $6,000 in earnings added to the account, and the balance in the account was $17,400 **after** taking a 2002 distribution of $6,600 for tuition payments. **The amount of the 2002 distribution attributable to earnings is $1,650, computed as follows:**

Step 1	
Amount of the 2002 distribution	$6,600
÷ Year end 2002 balance including distribution	÷ $24,000
Equals a Percentage of. . .	27.5%
Step 2	
The total earnings in the account as of December 31, 2002 including those distributed	6,000
	× 27.5%
	$1,650

Therefore, the amount of the 2002 distribution that is considered earnings is $1,650. This amount is tax-free.

> **Note.** On July 22, 2002, Illinois Governor George H. Ryan signed a bill that makes withdrawals from an out-of-state I.R.C. §529 plans taxable for Illinois state income tax.

Prepaid Tuition Plan Distribution Rules for 2002

If tuition credits were purchased, **the part of a distribution that is considered earnings** is the value of the credits at the time of distribution, minus the return of investment portion of the distribution. The return of investment portion is computed by dividing the investment in the account at the end of the year in which the distribution was made (including any return of investment made during the year) by the number of credits in the account at the end of the year (including those distributed during the year) and then multiplying the result by the number of credits distributed during the current year.

Example 3. Assume the same facts as in **Example 2**, except Billy's parents purchased 8 semesters of tuition credits with the $18,000. Billy attended the university for two semesters in 2002. **The amount attributable to earnings is $2,100, computed as follows:**

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Current value of two units distributed in 2002		$6,600
Investment as of 12/31/2002 (including amount distributed)	$18,000	
Divided by the number of units purchased	÷ 8	
Equals the per unit investment	$2,250	
Multiplied by the number of units distributed	× 2	
Return of investment portion of the 2002 distribution		(4,500)
Amount of the distribution that is considered earnings		$2,100

Note. In both of the above examples, the amount of qualified college expenses **exceeds** the amount of earnings distributed. Therefore, there would be no tax consequences to Billy. However, additional computations would be required if there were scholarships, excludable employer-provided educational assistance, a distribution from an education IRA, or if the Hope or Lifetime Learning credits were claimed for Billy. The return of the investment portion of the 2002 distribution **does not** qualify for the Hope or Lifetime Learning credit.

Penalty on refund of earnings. There is a 10% penalty on any distribution of earnings that does **not meet at least one** of the following conditions:

- The distributed earnings are used to pay qualified higher education expenses of the beneficiary.
- The distribution of earnings is made because of the death or disability of the beneficiary.
- The distribution of earnings is made because the beneficiary received a scholarship or other nontaxable payment other than a gift or inheritance for educational expenses. This applies only to the part of the distribution that is not more than the scholarship or other nontaxable payment.

CONTRIBUTION RULES FOR I.R.C. §529 PLANS FOR 2002

An individual may contribute to an I.R.C. §529 plan regardless of his/her AGI. As mentioned earlier, qualified tuition plans typically allow a person to contribute a much larger sum of money to provide for future college expenses. In 2002, married couples may be able to contribute up to $110,000 to an I.R.C. §529 plan (subject to any state-imposed limits) without any gift tax liability. Because of gift-splitting rules, a husband and wife may each contribute $55,000 tax-free by electing to spread the amounts over a 5-year period. No additional contributions may be made to the I.R.C. §529 plan of the child during the next five years without creating potential gift tax liability.

The parents retain control of the I.R.C. §529 plan assets, similar to a Uniform Gift to Minors Act (UGMA) account. However, the potential of tax deferral and the tax-free benefit of I.R.C. §529 distributions will usually be preferable to a UGMA account. There has been substantial movement of funds from UGMA accounts into I.R.C. §529 plans. These transfers will be taxable to the extent that the account value exceeds the taxable basis. The amounts contributed to an I.R.C. §529 plan are not included in the estate of the donor(s). If a donor has made the election to contribute five years in advance and dies during the 5-year period, the total amount contributed is prorated, and a portion is included in the donor's estate. Because there is no maximum age requirement for an I.R.C. §529 beneficiary, an account could be established to pay for the donor's college expenses. If a portfolio shift is desired (for example, from one mutual fund to another), a transfer (rollover) may be made **once in a 12-month period** to another I.R.C. §529 plan for the same beneficiary.

Note. There are two informative web sites for analyzing the various state I.R.C. §529 plans. They are: *www.collegesavings.org* and *www.savingforcollege.com*.

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COVERDELL EDUCATION SAVINGS ACCOUNTS (ESA)

Effective July 26, 2001, all education IRAs have been renamed Coverdell Education Savings Accounts (ESAs). I.R.C. §530 governs these accounts. A Coverdell ESA is a trust or custodial account created to pay **qualified education expenses** of the **designated beneficiary** of the account. The document creating and governing the account must be in writing and must satisfy the following requirements:

- The trustee or custodian must be a bank or an entity approved by the IRS.
- The trustee or custodian can only accept a contribution **made before the beneficiary reaches age 18** (not applicable to a special needs beneficiary) and **limited to $2,000 in 2002** (prior law limitation was $500).
- Money in the account cannot be invested in life insurance contracts.
- The balance in the account generally must be withdrawn **within 30 days after the earlier** of the beneficiary reaching age 30 (except for a special needs beneficiary) or the death of the beneficiary.

QUALIFIED EDUCATION EXPENSES

Qualified education expenses are expenses required for enrollment or attendance at an eligible educational institution. These expenses include qualified **higher education** expenses [I.R.C. §529(e)(3)] and qualified **elementary and secondary education** expenses [I.R.C. §530(b)(4)].

There are **three** categories of qualified **elementary and secondary** costs:

1. Tuition, fees, academic tutoring, books, supplies, and other equipment, and special needs services in the case of a special needs beneficiary. The costs must be incurred in connection with the designated beneficiary's enrollment as an elementary or secondary school student at a public, private, or religious school.
2. Room and board, uniforms, transportation and supplementary items and services (including extended day programs) that are required or provided by a public, private, or religious school in connection with the attendance of the beneficiary at the school.
3. The purchase of any computer technology or equipment or for Internet access and related services if the technology, equipment, or services are to be used by the beneficiary and the beneficiary's family during any of the years that the beneficiary is in school (not including expenses for computer software designed for sports, games, or hobbies unless the software is predominantly educational in nature).

Note. I.R.C. §530(b)(1)(e) states that a designated beneficiary with special needs will be determined under regulations prescribed by the Secretary. When regulations are issued, this definition will likely be different than the one for special needs for purposes of the adoption credit.

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WHAT ARE THE CONTRIBUTION LIMITS FOR A COVERDELL ESA?

Excerpt from IRS Pub. 970, *Tax Benefits for Higher Education.*

Coverdell ESA Contributions at a Glance

Question	Answer
Are contributions deductible?	No.
Why should someone contribute to a Coverdell ESA?	Earnings on the account grow tax free until withdrawn.
What is the contribution limit per designated beneficiary?	$500 in 2001 for each designated beneficiary. $2,000 in 2002.
What if more than one Coverdell ESA has been opened for the same beneficiary?	The annual contribution limit is $500 for 2001 ($2,000 for 2002) for each beneficiary, no matter how many Coverdell ESAs are set up for that beneficiary.
What if more than one individual makes contributions for the same beneficiary?	The annual contribution limit is $500 for 2001 ($2,000 for 2002) for each beneficiary, no matter how many individuals contribute.
Can contributions other than cash be made to a Coverdell ESA?	No.
When must contributions stop?	In 2001, no contributions can be made to a beneficiary's Coverdell ESA after he/she reaches age 18. Beginning in 2002, contributions can be made to a Coverdell ESA for a special needs beneficiary after he/she reaches age 18.

There are **two** annual contribution limits. There is a **limit** on the total amount that can be contributed for **each designated beneficiary** in any year, and a **limit** (based on AGI) on the amount that **any individual can contribute for any one designated beneficiary** for a year. A beneficiary does **not** need to be related to a donor. Contributions are not tax deductible. Under prior law, contributions had to be made by December 31. The 2001 Act extended the deadline to April 15 following the close of the tax year. Therefore, most taxpayers will have until April 15, 2003 to make contributions for the 2002 tax year.

Limits for Each Designated Beneficiary

The total of all 2002 tax year contributions to all Coverdell ESAs established for any one designated beneficiary cannot be more than $2000. Under prior law, the maximum was only $500.

Limits for Each Contributor

In 2002, if modified AGI is between $95,000 and $110,000 **for a taxpayer other than a joint filer,** the $2000 limit is gradually phased out. **If 2002 modified AGI exceeds $110,000, a taxpayer other than a joint filer cannot contribute to a Coverdell ESA.** The phase-out for 2002 joint-return filers begins at $190,000 of modified AGI, and is completely phased out at $220,000 of modified adjusted gross income. These limits, which are **double** those of single taxpayers, were $150,000 to $160,000 under prior law. **Therefore, a joint-return filer with 2002 modified AGI over $220,000 cannot contribute to a Coverdell ESA.**

Example 4. Chuck's parents and grandparents both want to contribute to his Coverdell ESA for the 2002 tax year. This is permissible, but the total amount contributed on Chuck's behalf cannot exceed a total of $2000.

Example 5. Assume the same facts as **Example 4**, except Chuck's grandparents have a modified AGI of $300,000 on their 2002 joint return. They cannot contribute to Chuck's Coverdell ESA for the 2002 tax year.

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Example 6. Assume the same facts as **Example 4**, except Chuck's grandparents have a 2002 modified AGI of $208,000. The maximum Chuck's grandparents can contribute is $800, computed as follows:

1. $208,000 – $190,000 (beginning of phase-out range) = $18,000
2. $18,000 ÷ $30,000 ($220,000 – $190,000) = 60%
3. 60% × $2,000 = $1,200 phase-out amount
4. $2,000 – $1,200 = **$800 maximum contribution**

Modified AGI is determined by adding the following items to adjusted gross income on line 33:

- The foreign income exclusion from Form 2555, line 40 or Form 2555-EZ, line 18
- The foreign income housing exclusion from Form 2555, line 34
- Any exclusion of income from Puerto Rico
- Any income from American Samoa excluded from Form 4563, line 15

ADDITIONAL TAX ON EXCESS CONTRIBUTIONS

The **beneficiary** must pay a 6% excise tax each year on excess contributions that are not withdrawn by the due date of the beneficiary's return for the year (including extensions). This additional tax under I.R.C. §4973 does not apply to any rollover contribution. If excess contributions are made and later withdrawn before the due date of the beneficiary's return, the **withdrawn earnings** must be included in the beneficiary's income for the year in which the excess contribution was made. This additional tax is computed in Part V of Form 5329 and reported on line 55, Form 1040 of the beneficiary.

Example 7. Assume the same facts as **Example 6**, except **Chuck's parents** (whose 2002 modified AGI was below $190,000) and **Chuck's grandparents** both contributed $2,000 for the 2002 tax year to Chuck's Coverdell ESA. It is irrelevant if the $4,000 was contributed to single or multiple accounts.

With these facts, there are excess contributions that must be withdrawn by the due date of Chuck's 2002 return in order for him to avoid tax on the excess contribution reported on Form 5329. Assume Chuck's grandparents withdraw their entire $2,000 contribution. In that case, Chuck will not be liable for any additional tax. However, he must report any earnings on his grandparents' $2,000 withdrawn contribution on his 2002 return.

ROLLOVERS AND OTHER TRANSFERS

Assets can be rolled over from one Coverdell ESA to another in order to change a designated beneficiary or to implement a new investment strategy. A distribution that is rolled over to another Coverdell ESA for the benefit of the same beneficiary, or a member of the beneficiary's family who is under age 30, is **not** taxable if it is deposited into the new account within 60 days.

The following are considered members of the beneficiary's family:

- The beneficiary's spouse, child, grandchild, or stepchild
- A brother, sister, half-brother, half-sister, stepbrother, or stepsister
- A father, mother, grandfather, grandmother, stepfather, or stepmother
- A brother or sister of the beneficiary's father or mother (aunt or uncle)
- A son or daughter of the beneficiary's brother or sister (niece or nephew)
- A son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law
- A spouse of any of the above individuals

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Only one rollover is allowed during the 12-month period ending on the date of the payment or withdrawal. If a spouse or former spouse receives a Coverdell ESA under a divorce decree, it is not a taxable transfer. After the transfer, the receiving spouse treats the Coverdell ESA as his/her own.

WITHDRAWALS FROM A COVERDELL ESA

Excerpt from IRS Pub. 970, *Tax Benefits for Higher Education.*

Coverdell ESA Withdrawals at a Glance

Question	Answer
Is a withdrawal from a Coverdell ESA to pay for a designed beneficiary's qualified education expenses tax-free?	Generally, yes, to the extent the amount of the withdrawal is not more than the designed beneficiary's qualified education expenses.
After the designed beneficiary completed his/her education at an eligible educational institution, may amounts remaining in the Coverdell ESA be withdrawn?	Yes. Amounts must be withdrawn when the designated beneficiary reaches age 30. (Beginning in 2002, this does not apply to a special needs beneficiary.) Also, certain transfers to **members of the beneficiary's family** are permitted.
Does the designated beneficiary need to be enrolled for a minimum number of courses to take a tax-free withdrawal?	No.

The designated beneficiary of a Coverdell ESA can take withdrawals at any time. **The withdrawals are tax-free if they do not exceed the beneficiary's qualified education expenses for the tax year.** The beneficiary does not need to be enrolled for a minimum number of courses to take a tax-free withdrawal**. If the beneficiary has completed his/her education, he/she may transfer the amounts to a family member.**

Amounts must be withdrawn or transferred within 30 days of the designated beneficiary's 30th birthday (unless the beneficiary is considered special needs). If the designated beneficiary dies before reaching age 30, the remaining assets must be withdrawn or transferred within 30 days. Withdrawals are reported in Part V of Form 5329 (Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts). The earnings portion of a withdrawal is taxable to the beneficiary if the withdrawals exceed the beneficiary's qualified education expenses for the tax year.

Example 8. Darrell took a $1,000 distribution from his Coverdell ESA in August 2002. A total of $2,000 had been contributed to the account prior to 2002.

The balance in the account before the distribution was $2,500. The value of the account as of December 31, 2002 was $2,500. Darrell paid only $600 of qualified education expenses in 2002.

To compute the taxable portion:

Step 1. Multiply the distribution by a fraction. The numerator is the total contributions in the account ($2,000). The denominator is the total balance in the account before the withdrawal ($2,500).

$1,000 × ($2,000 ÷ $2,500) = **$800 return of contributions**

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Note. The return of investment portion of the 2002 distribution **does not** qualify for the Hope or Lifetime Learning credit. However, beginning in 2002, the Hope or Lifetime Learning credits and the Coverdell ESA can be used to pay for qualified education expenses of the same individual, provided the same funds are not used to obtain both benefits.

Step 2. Subtract $800 from the total withdrawal of $1,000 to determine the $200 amount of earnings included in the withdrawal.

$1,000 – $800 = **$200 earnings withdrawn**

Step 3. Multiply the amount of distribution by a fraction. The numerator is the amount of qualified education expenses paid during the year ($600), and the denominator is the total amount withdrawn during the year ($1,000).

$200 × ($600 ÷ $1,000) = **$120 tax-free portion of earnings withdrawn**

Step 4. The remaining $80 of earnings withdrawn ($200 - $120) is taxable because it was not used to pay qualified education expenses.

See Darrell's completed 2002 Form 5329, Part II on the following pages:

Darrell would also be liable for a 10% penalty tax on the $80 taxable distribution on his 2002 Form 5329.

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For Example 8

Form **5329**

Department of the Treasury
Internal Revenue Service

Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts

► Attach to Form 1040.
► See separate instructions.

OMB No. 1545-0203

2002

Attachment Sequence No. **29**

Name of individual subject to additional tax. If married filing jointly, see page 1 of the instructions.

Darrell

Your social security number
111 11 1111

Fill in Your Address Only If You Are Filing This Form by Itself and Not With Your Tax Return

Home address (number and street), or P.O. box if mail is not delivered to your home

Apt. no.

City, town or post office, state, and ZIP code

If this is an amended return, check here ► ☐

If you **only** owe the additional 10% tax on early distributions, you may be able to report this tax directly on Form 1040 without filing Form 5329. See the instructions for Form 1040, line 58.

Draft as of April 8, 2002

Part I Additional Tax on Early Distributions

Complete this part if you took a taxable distribution, before you reached age 59½, from a qualified retirement plan (including an IRA) or modified endowment contract (unless you are reporting this tax directly on Form 1040—see above). You also may have to complete this part if you received a Form 1099-R that incorrectly indicates an early distribution or you received a Roth IRA distribution (see instructions).

1	Early distributions included in income. For Roth IRA distributions, see instructions	1	
2	Early distributions included on line 1 that are not subject to the additional tax (see instructions). Enter the appropriate exception number from the instructions: _____	2	
3	Amount subject to additional tax. Subtract line 2 from line 1	3	
4	**Additional tax.** Enter 10% (.10) of line 3. Include this amount on Form 1040, line 58	4	
	Caution: *If any part of the amount on line 3 was a distribution from a SIMPLE IRA, you may have to include 25% of that amount on line 4 instead of 10% (see instructions).*		

Part II Additional Tax on Certain Distributions From Education Accounts

Complete this part if you included an amount in income, on Form 1040, line 21, from a Coverdell education savings account (ESA) or a qualified tuition program (QTP).

5	Distributions included in income from Coverdell ESAs and QTPs	5	80
6	Distributions included on line 5 that are not subject to the additional tax (see instructions)	6	0
7	Amount subject to additional tax. Subtract line 6 from line 5	7	80
8	**Additional tax.** Enter 10% (.10) of line 7. Include this amount on Form 1040, line 58	8	8

Part III Additional Tax on Excess Contributions to Traditional IRAs

Complete this part if you contributed more to your traditional IRAs for 2002 than is allowable or you had an amount on line 17 of your 2001 Form 5329.

9	Enter your excess contributions from line 16 of your 2001 Form 5329. If zero, go to line 15		9	
10	If your traditional IRA contributions for 2002 are less than your maximum allowable contribution, see instructions. Otherwise, enter -0-	10		
11	2002 traditional IRA distributions included in income (see instructions)	11		
12	2002 distributions of prior year excess contributions (see instructions)	12		
13	Add lines 10, 11, and 12		13	
14	Prior year excess contributions. Subtract line 13 from line 9. If zero or less, enter -0-		14	
15	Excess contributions for 2002 (see instructions)		15	
16	Total excess contributions. Add lines 14 and 15		16	
17	**Additional tax.** Enter 6% (.06) of the **smaller** of line 16 **or** the value of your traditional IRAs on December 31, 2002 (including 2002 contributions made in 2003). Include this amount on Form 1040, line 58		17	

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There are several exceptions. The beneficiary does **not** have to pay the 10% penalty tax for the following types of withdrawals:

- Paid to a beneficiary (or to the estate of the designated beneficiary) on or after the death of the designated beneficiary.

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- Made because the beneficiary is disabled. The beneficiary is considered to be disabled if he or she shows proof that he or she cannot do any substantial gainful activity because of his or her physical or mental condition. A physician must determine that the beneficiary's condition can be expected to result in death or to be of long-continued and indefinite duration.
- Made because the beneficiary received a qualified scholarship, an educational assistance allowance, or a payment for the beneficiary's educational expenses that is excludable from gross income to the extent the withdrawal is not more than the scholarship, allowance, or payment.
- A return of an excess contribution (and any earnings on it) before the due date of the beneficiary's tax return (including extensions). If the beneficiary does not have to file a return, the excess (and any earnings) must be withdrawn by April 15 of the year following the year of the contribution.

HOPE CREDIT — I.R.C. §25A

GENERAL PROVISIONS

The Hope Scholarship credit is a **nonrefundable** credit of up to $1,500 per eligible student. It is equal to 100% of the first $1,000 and 50% of the next $1,000 of qualified tuition and related expenses paid during the year. Part I of Form 8863 is used to claim the Hope credit. Qualified tuition and related expenses include **tuition and fees required for the enrollment or attendance of an eligible student at an eligible educational institution.**

The following expenses are **not** qualified tuition and related expenses:

- Charges and fees associated with meals, lodging, student activities, athletics, insurance, transportation, and similar personal, living, or family expenses are not included, even if the fee must be paid to the institution as a condition of enrollment or attendance.
- The expenses of education involving sports, games, or hobbies are not qualified tuition expenses unless this education is part of the student's degree program.
- Expenses paid for any noncredit course.
- Qualified tuition and related expenses do not include expenses covered by educational assistance that is not required to be included in the gross income of either the student or the taxpayer claiming the credit. Thus, total qualified tuition and related expenses are reduced by any scholarship or fellowship grants excludable from gross income under present law and any other tax-free educational benefits received by the student during the taxable year.

> **Note.** A student may choose to include an otherwise nontaxable grant as taxable income on the student's tax return. If this option is chosen, the converted taxable grant does not reduce expenses qualifying for the Hope Credit [Proposed Reg. 1.25A-5(c)(3)(i)].

Other special provisions regarding qualified tuition and related expenses:

- No reduction of qualified tuition and related expenses is required for a gift, bequest, devise, or inheritance within the meaning of I.R.C. §102(a).
- A Hope credit is not allowed with respect to any education expense for which a deduction is claimed under I.R.C. §162 (ordinary and necessary business expense) or any other section of the Internal Revenue Code.
- Generally, prepaid expenses do not qualify for the Hope credit. However, if tuition and fees are paid during a tax year for an academic term that begins in the first three months of the next tax year, the academic term is treated as if it began in the tax year the expenses are paid. Therefore, the taxpayer can claim a Hope credit for those expenses only for the tax year they are paid.

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Example 9. Ed paid $1,500 for tuition at a university in **2002**. Ed received a non-taxable scholarship that covered the other $3,000 of the total tuition of $4,500. Only the $1,500 will qualify as qualified education expenses. If Ed otherwise qualifies, his Hope credit will be $1,250 ($1,000 plus 50% of $500).

Example 10. Frank paid a total of **$5,000** for tuition at a university in **2002**. He paid **$1,500** with funds from his own savings account, and received a **$3,500** gift from his grandparents which he used to pay the balance. The entire $5,000 is considered qualified expenses. On Form 8863, only the first $2,000 of qualified expenses are shown in Part I. The allowable Hope credit (if Frank otherwise qualifies) is the maximum of $1,500.

Example 11. Greg paid **$3,000** for tuition in July for the fall semester of **2002** and another **$3,000** for winter semester tuition in December of **2002**. The winter semester starts in January of **2003**. The entire **$6,000** would be considered qualified expense on Greg's **2002** Form 8863. The $6,000 was paid in **2002** and the winter semester begins in the first three months of the next tax year.

Qualified Taxpayers. A taxpayer can claim the Hope credit for tuition and fees paid for himself or herself, his/her spouse, or a person who is claimed as a dependent on the taxpayer's tax return. A student who is a dependent on another taxpayer's tax return **cannot** claim the credit, but any qualifying expense paid by the student is treated as paid by the taxpayer who claims the student as a dependent. Typically, the other taxpayer(s) are the parent(s).

Third party payments. If a **third party** pays qualified educational expenses **directly** to the educational institution, the payments are treated as if the money has been given to the student and the student paid the expenses. A third party is defined in the proposed regulations as someone other than the taxpayer, the taxpayer's spouse, or a claimed dependent.

Not claiming a dependent. If a taxpayer is eligible to claim a student as a dependent but does not, the student (and only the student) may claim the Hope credit. The proposed regulation does not allow a student to claim himself or herself as a personal exemption deduction if someone else is eligible to claim the exemption under I.R.C. §151(d)(2). **Therefore, if parents are eligible to but do not claim the student as a dependent, no one is entitled to the personal exemption deduction**.

Example 12. Henry attended the local college in **2002**. He paid $1,000 of his tuition with money from his summer job. The remaining $1,000 was paid by Henry's parents. If Henry's parents claim Henry as a dependent, the entire $2,000 tuition payment will be reported in Part I on the parents' 2002 Form 8863.

Example 13. If Henry's parents do **not** claim him as a dependent, the entire $2,000 tuition payment are considered paid by Henry, and he would be entitled to the Hope credit. The payments made by the parents would be considered a gift to Henry.

Example 14. If Henry's parents are eligible to claim his personal exemption but do not receive a tax benefit due to the high AGI phase-out rules, no one will receive a benefit for his personal exemption. Henry is the only one who could claim the Hope credit.

Example 15. Assume the same facts as **Example 12**, except the remaining $1,000 of the tuition was paid directly to the educational institution by Henry's grandparents. If Henry's parents claim him as a dependent, they are entitled to report the entire $2,000 tuition payment on their 2002 Form 8863. This is true even though **none** of the tuition was paid by them.

Example 16. Henry's parents are divorced. His father paid the tuition, but his mother is entitled to Henry's dependency exemption. All of the tuition payments made by **both** parents will be considered as paid by Henry's mother because she is entitled to the dependency exemption.

Degree Requirement. The Hope credit can be claimed only for an individual who enrolls at an eligible institution in a program leading toward a post-secondary degree, certificate, or other recognized credential.

Eligible Institution. An eligible institution includes any accredited post-secondary educational institution eligible to participate in a student aid program administered by the federal Department of Education. It includes virtually all accredited public, nonprofit, and proprietary (privately owned and profit-making) institutions. Consequently, vocational and trade schools are included, as well as colleges and universities.

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Work Load Requirement. The Hope credit can be claimed only for an individual who is **at least a half-time student** for at least one academic term that begins during the tax year. Correspondence study alone cannot qualify. The standard for what constitutes "half of the normal full-time workload" is determined by each eligible educational institution.

Year of Study Requirement. Before the beginning of the tax year, the student must have completed **less than two years** of post-secondary education. The test of whether a student has completed two years of post-secondary education is based on the academic credit awarded by the institution for coursework completed by the student **prior to the beginning of the tax year**. Academic credit awarded by the institution solely on the basis of the student's performance on proficiency examinations is disregarded.

Felony Drug Conviction Requirement. If the student has been convicted of a federal or state felony offense for possession or distribution of a controlled substance as of the end of the taxable year, he/she is **not** an eligible student.

LIMITATIONS

The Hope credit cannot be claimed if it was claimed in two prior tax years with respect to the same student. This is a different 2-year requirement than the first two years of post-secondary education requirement discussed above. Both requirements must be met. The Hope credit is reduced if a taxpayer's 2002 modified AGI exceeds $41,000 ($82,000 for married taxpayers who file a joint return). **If a taxpayer's 2002 modified AGI exceeds $51,000 ($102,000 for married taxpayers who file a joint return), no Hope credit can be claimed.** A Hope credit can be claimed for qualified expenses that were paid with the proceeds of a loan.

Example 17. Ike began his college education as a freshman in the fall of **2000**. He became a sophomore in the fall of **2001**, and a junior in the fall of **2002**. Because he was still considered a sophomore at the beginning of 2002, he would be eligible to claim the Hope credit for all expenses paid in 2002. However, if he claimed the Hope credit in **2000** and in **2001**, he would **not** be able to claim it again in **2002**, because it can only be claimed in two tax years.

However, Ike or his parents should consider **either** the Lifetime Learning Credit or the new Higher Education Expense Deduction for the **2002** tax year. Both of these education provisions are explained later in this chapter.

Example 18. Cindy Hart entered college in August 2002. Her parents, Jerry and Janet Hart, have 2002 modified AGI of $90,000. Due to the AGI limitation, their tentative 2002 $1,500 Hope credit for Cindy is limited to **$900**. The completed 2002 Form 8863 is shown on the following page.

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For Example 18

Form **8863** — Department of the Treasury, Internal Revenue Service

Education Credits (Hope and Lifetime Learning Credits)

▶ See instructions. ▶ Attach to Form 1040 or Form 1040A.

OMB No. 1545-1618

2002

Attachment Sequence No. 50

Name(s) shown on return: **Jerry and Janet Hart**

Your social security number: **777 77 7777**

Draft as of 7/15/2002

Part I Hope Credit. Caution: *The Hope credit may be claimed for no more than* **2** *tax years for the* ***same*** *student.*

1 (a) Student's name (as shown on page 1 of your tax return) First name / Last name	(b) Student's social security number (as shown on page 1 of your tax return)	(c) Qualified expenses (but **do not** enter more than $2,000 for each student). See instructions	(d) Enter the **smaller** of the amount in column (c) or $1,000	(e) Subtract column (d) from column (c)	(f) Enter one-half of the amount in column (e)
Cindy Hart	222 22 222	2,000	1,000	1,000	500

2	Add the amounts in columns (d) and (f)	2	500
3	Tentative Hope credit. Add the amounts on line 2, columns (d) and (f). If you are claiming the lifetime learning credit, go to Part II; otherwise, go to Part III ▶	3	1,500

Part II Lifetime Learning Credit

4 **Caution:** *You cannot take the Hope credit and the lifetime learning credit for the same student.*	(a) Student's name (as shown on page 1 of your tax return) First name / Last name	(b) Student's social security number (as shown on page 1 of your tax return)	(c) Qualified expenses. See instructions

5	Add the amounts on line 4, column (c), and enter the total	5	
6	Enter the **smaller** of line 5 or $5,000	6	
7	Tentative lifetime learning credit. Multiply line 6 by 20% (.20) and go to Part III ▶	7	

Part III Allowable Education Credits

8	Tentative education credits. Add lines 3 and 7			8	1,500
9	Enter: $102,000 if married filing jointly; $51,000 if single, head of household, or qualifying widow(er)	9	102,000		
10	Enter the amount from Form 1040, line 36 (or Form 1040A, line 22)*	10	90,000		
11	Subtract line 10 from line 9. If line 10 is equal to or more than line 9, **stop;** you cannot take any education credits	11	12,000		
12	Enter: $20,000 if married filing jointly; $10,000 if single, head of household, or qualifying widow(er)	12	20,000		
13	If line 11 is equal to or more than line 12, enter the amount from line 8 on line 14 and go to line 15. If line 11 is less than line 12, divide line 11 by line 12. Enter the result as a decimal (rounded to at least three places)			13	× .60
14	Multiply line 8 by line 13 ▶			14	900
15	Enter the amount from Form 1040, line 44 (or Form 1040A, line 28)			15	12,864
16	Enter the total, if any, of your credits from Form 1040, lines 45 through 47 (or from Form 1040A, lines 29 and 30)			16	0
17	Subtract line 16 from line 15. If line 16 is equal to or more than line 15, **stop;** you cannot take any education credits			17	12,864
18	**Education credits.** Enter the **smaller** of line 14 or line 17 here and on Form 1040, line 48 (or Form 1040A, line 31) ▶			18	900

*See Pub. 970 for the amount to enter if you are filing Form 2555, 2555-EZ, or 4563 or you are excluding income from Puerto Rico.

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Modified AGI is defined as adjusted gross income increased by any of the following:

- The foreign earned income exclusion under I.R.C. §911
- The exclusion for income from Guam, American Samoa, or the Northern Mariana Islands under I.R.C. §931
- The exclusion for income from Puerto Rico under I.R.C. §933

Married taxpayers are not allowed to claim the Hope credit unless they file a joint income tax return for the year. Taxpayers who are considered unmarried under the head of household rules are considered unmarried for this rule.

EFFECT ON OTHER INCOME TAX PROVISIONS

The Lifetime Learning credit cannot be claimed for expenses incurred for a student if the Hope credit is claimed for any expenses of that student for the same tax year. If qualified higher education expenses are used in determining the Hope credit, **the same expenses cannot** be used to calculate the interest exclusion from U.S. savings bonds on **Form 8815**.

Beginning in 2002, a taxpayer may be able to claim a Hope credit in the same year in which he/she receives a distribution from either a Coverdell ESA or a qualified tuition program. The only restriction is that qualified education expenses may not be used for more than one tax benefit. Expenses paid with the proceeds from a distribution from either a Coverdell ESA or a qualified tuition program under I.R.C. §529 may not use those expenses as the basis for claiming the Hope or Lifetime Learning credits.

> **Note.** With the advent of the maximum $3,000 Higher Education Expense Deduction in 2002, many taxpayers will have to choose between the Hope credit and the new deduction. For married taxpayers whose 2002 modified AGI is below the Hope credit phase-out floor of $82,000, the obvious choice is the $1,500 (maximum) Hope credit. For married taxpayers whose 2002 modified AGI is above $102,000, but less than $130,000, the obvious choice is the $3,000 (maximum) deduction which is allowable in arriving at 2002 AGI. For married taxpayers whose 2002 modified AGI is between $82,000 and $102,000, calculations are necessary to determine which choice yields the most tax savings.

LIFETIME LEARNING CREDIT — I.R.C. §25A

GENERAL PROVISIONS

The Lifetime Learning credit is a **nonrefundable** credit of up to $1,000. Beginning in **2003**, the maximum amount of the credit increases to **$2,000**. The credit is equal to 20% of the first $5,000 of qualified tuition and fees paid in years **prior to 2003** for an academic period beginning in 2002 or in the first three months of 2003.

The definitions of qualified tuition and related expenses and eligible educational institution are the same as those for the Hope credit.

Unlike the Hope credit, the Lifetime Learning credit can be claimed for **all** undergraduate (not just freshmen and sophomores) and graduate students. The Lifetime Learning credit can also be claimed for students who are **not** in a program leading to a degree or certificate, if the education is for the purpose of acquiring or improving job skills. A student does not need to be enrolled half-time to be eligible.

Also unlike the Hope credit, the **Lifetime Learning credit is not limited to two tax years**. It can be claimed in any year in which there are qualifying expenses.

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Excerpt from IRS Pub. 970, *Tax Benefits for Higher Education*.

Comparison of Education Credits for 2002

Lifetime Learning Credit	Hope Scholarship Credit
Up to $1,000 credit per **return.**	Up to $1,500 credit per **eligible student.**
Available for all years of post-secondary education.	Available ONLY for the first two years of post-secondary education.
Available for an unlimited number of years.	Available ONLY for two years per eligible student.
Student does not need to be pursuing a degree or other recognized educational credit.	Student must be pursuing a degree or other recognized educational credential.
Available for one or more courses.	Student must be enrolled at least half-time for at least one academic period beginning during the year.
Felony drug conviction rule does not apply.	No felony drug conviction on student's record.

The 2001 Act now allows a taxpayer to claim a Lifetime Learning credit in the same year in which a distribution is received from a Coverdell ESA or an I.R.C. §529 qualified tuition program. The expenses paid with the distribution from the Coverdell ESA or qualified tuition program under I.R.C. §529 **cannot be duplicated** as qualifying expenses for the Hope or Lifetime Learning credits.

Example 19. Ken had **$6,000** of qualifying educational expenses in **2002**. He took a distribution from his Coverdell ESA to pay for **$1,000** of the expenses. The remaining **$5,000** would be eligible for either the Hope or Lifetime Learning credits.

LIMITATIONS

Per-Taxpayer Credit. Only one $1,000 ($2,000 beginning in 2003) Lifetime Learning credit is allowed for a taxpayer each year. By contrast, a maximum $1,500 Hope credit can be claimed by a taxpayer for **each** eligible student **each** year. The tentative credit is computed in Part II of Form 8863.

Example 20. Larry Scott, his wife Mary, and their dependent son, Ned, all had qualifying educational expenses in **2002**:

- Larry paid **$1,500** for home improvement courses at the local junior college.
- Mary paid **$2,000** for cosmetology classes at an accredited beauty college.
- Ned is a freshman at a state university. His tuition payments were **$4,000** for 2002.

Ned's expenses would qualify for either the Hope or the Lifetime Learning credit. Larry and Mary's expenses qualify only for the Lifetime Learning credit. **Their two options for 2002 are shown on the following Forms 8863.** The first option gives them the **largest** credit in 2002 and is preferable to the second option.

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For Example 20, Option One

Form **8863**

Department of the Treasury
Internal Revenue Service

Education Credits (Hope and Lifetime Learning Credits)

▶ See instructions. ▶ Attach to Form 1040 or Form 1040A.

OMB No. 1545-1618

2002

Attachment Sequence No. **50**

Name(s) shown on return: **Larry and Mary Scott**

Your social security number: **444 44 4444**

Part I Hope Credit. Caution: *The Hope credit may be claimed for no more than* ***2*** *tax years for the* ***same*** *student.*

1 (a) Student's name (as shown on page 1 of your tax return) First name / Last name	(b) Student's social security number (as shown on page 1 of your tax return)	(c) Qualified expenses (but **do not** enter more than $2,000 for each student). See instructions	(d) Enter the **smaller** of the amount in column (c) or $1,000	(e) Subtract column (d) from column (c)	(f) Enter one-half of the amount in column (e)
Ned Scott	**888 88 8888**	**2,000**	**1,000**	**1,000**	**500**

2	Add the amounts in columns (d) and (f)	2	500
3	Tentative Hope credit. Add the amounts on line 2, columns (d) and (f). If you are claiming the lifetime learning credit, go to Part II; otherwise, go to Part III ▶	3	1,500

Part II Lifetime Learning Credit

4 **Caution:** *You cannot take the Hope credit and the lifetime learning credit for the same student.*

(a) Student's name (as shown on page 1 of your tax return) First name / Last name	(b) Student's social security number (as shown on page 1 of your tax return)	(c) Qualified expenses. See instructions
Larry Scott	**444 44 4444**	**1,500**
Mary Scott	**555 55 5555**	**2,000**

5	Add the amounts on line 4, column (c), and enter the total	5	3,500
6	Enter the **smaller** of line 5 or $5,000	6	3,500
7	Tentative lifetime learning credit. Multiply line 6 by 20% (.20) and go to Part III ▶	7	700

Part III Allowable Education Credits

8	Tentative education credits. Add lines 3 and 7			8	2,200
9	Enter: $102,000 if married filing jointly; $51,000 if single, head of household, or qualifying widow(er)	9	102,000		
10	Enter the amount from Form 1040, line 36 (or Form 1040A, line 22)*	10	81,000		
11	Subtract line 10 from line 9. If line 10 is equal to or more than line 9, **stop;** you cannot take any education credits	11	21,000		
12	Enter: $20,000 if married filing jointly; $10,000 if single, head of household, or qualifying widow(er)	12	20,000		
13	If line 11 is equal to or more than line 12, enter the amount from line 8 on line 14 and go to line 15. If line 11 is less than line 12, divide line 11 by line 12. Enter the result as a decimal (rounded to at least three places)			13	× .
14	Multiply line 8 by line 13 ▶			14	2,200
15	Enter the amount from Form 1040, line 44 (or Form 1040A, line 28)			15	11,103
16	Enter the total, if any, of your credits from Form 1040, lines 45 through 47 (or from Form 1040A, lines 29 and 30)			16	0
17	Subtract line 16 from line 15. If line 16 is equal to or more than line 15, **stop;** you cannot take any education credits			17	11,103
18	**Education credits.** Enter the **smaller** of line 14 or line 17 here and on Form 1040, line 48 (or Form 1040A, line 31) ▶			18	2,200

*See Pub. 970 for the amount to enter if you are filing Form 2555, 2555-EZ, or 4563 or you are excluding income from Puerto Rico.

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Draft as of 7/15/2002

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The second option illustrates the **per taxpayer** computation of the credit. If Larry and Mary were to choose Option Two, they would be able to claim Ned's Hope credit for two future years, as long as they claim him as a dependent in those years.

For Example 20, Option Two

Form **8863** — Department of the Treasury, Internal Revenue Service

Education Credits (Hope and Lifetime Learning Credits)

▶ See instructions. ▶ Attach to Form 1040 or Form 1040A.

OMB No. 1545-1618 — 2002 — Attachment Sequence No. 50

Name(s) shown on return: **Larry and Mary Scott**

Your social security number: **444 44 4444**

Draft as of 7/15/2002

Part I Hope Credit. **Caution:** *The Hope credit may be claimed for no more than **2** tax years for the **same** student.*

1 (a) Student's name (as shown on page 1 of your tax return) First name / Last name	(b) Student's social security number (as shown on page 1 of your tax return)	(c) Qualified expenses (but **do not** enter more than $2,000 for each student). See instructions	(d) Enter the **smaller** of the amount in column (c) or $1,000	(e) Subtract column (d) from column (c)	(f) Enter one-half of the amount in column (e)
2 Add the amounts in columns (d) and (f)			2		
3 Tentative Hope credit. Add the amounts on line 2, columns (d) and (f). If you are claiming the lifetime learning credit, go to Part II; otherwise, go to Part III ▶				3	

Part II Lifetime Learning Credit

4 **Caution:** *You cannot take the Hope credit and the lifetime learning credit for the same student.*

(a) Student's name (as shown on page 1 of your tax return) First name	Last name	(b) Student's social security number (as shown on page 1 of your tax return)	(c) Qualified expenses. See instructions
Ned	Scott	888 88 8888	4,000
Larry	Scott	444 44 4444	1,500
Mary	Scott	555 55 5555	2,000

5 Add the amounts on line 4, column (c), and enter the total	5	7,500
6 Enter the **smaller** of line 5 or $5,000	6	5,000
7 Tentative lifetime learning credit. Multiply line 6 by 20% (.20) and go to Part III ▶	7	1,000

Part III Allowable Education Credits

8 Tentative education credits. Add lines 3 and 7			8	1,000
9 Enter: $102,000 if married filing jointly; $51,000 if single, head of household, or qualifying widow(er)	9	102,000		
10 Enter the amount from Form 1040, line 36 (or Form 1040A, line 22)*	10	81,000		
11 Subtract line 10 from line 9. If line 10 is equal to or more than line 9, **stop;** you cannot take any education credits	11	21,000		
12 Enter: $20,000 if married filing jointly; $10,000 if single, head of household, or qualifying widow(er)	12	20,000		
13 If line 11 is equal to or more than line 12, enter the amount from line 8 on line 14 and go to line 15. If line 11 is less than line 12, divide line 11 by line 12. Enter the result as a decimal (rounded to at least three places)			13	× .
14 Multiply line 8 by line 13 ▶			14	1,000
15 Enter the amount from Form 1040, line 44 (or Form 1040A, line 28)			15	11,103
16 Enter the total, if any, of your credits from Form 1040, lines 45 through 47 (or from Form 1040A, lines 29 and 30)			16	0
17 Subtract line 16 from line 15. If line 16 is equal to or more than line 15, **stop;** you cannot take any education credits			17	11,103
18 **Education credits.** Enter the **smaller** of line 14 or line 17 here and on Form 1040, line 48 (or Form 1040A, line 31) ▶			18	1,000

*See Pub. 970 for the amount to enter if you are filing Form 2555, 2555-EZ, or 4563 or you are excluding income from Puerto Rico.

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Modified Adjusted Gross Income. The Lifetime Learning credit is subject to the same modified AGI limits as discussed for the Hope credit. The credit is phased out if a taxpayer's 2002 modified AGI is between $41,000 to $51,000 ($82,000 to $102,000 for married filing jointly). **Married taxpayers are not allowed to claim the Lifetime Learning Credit unless they file a joint income tax return for the year.**

As with the Hope credit, any qualified higher education expenses used in determining the Lifetime Learning credit cannot be duplicated when calculating the interest exclusion from U.S. savings bonds on Form 8815. Similarly, educational expenses cannot be used in determining the credit if they are deducted on the tax return on Schedule C or Schedule A.

The Hope and Lifetime Learning credits are elected credits. They are claimed on Form 8863 included with the taxpayer's timely filed (including extensions) return, or with an amended return filed within the statute of limitations [IRS Notice 99-32].

HIGHER EDUCATION EXPENSE DEDUCTION — I.R.C. §222

For tax years before 2002, taxpayers generally could not deduct their own education expenses or those of their dependents. Education expenses related to a taxpayer's employment or business could be deductible on either Form 2106 or Schedule C. If an employee incurred deductible education expenses, they were claimed as a miscellaneous itemized deduction subject to the 2% AGI floor on Schedule A.

GENERAL PROVISIONS AND LIMITATIONS

For the tax years **2002 through 2005**, a new deduction is allowed. I.R.C. §222(a) added an above-the-line deduction for **qualified tuition and related fees** incurred by a taxpayer during the tax year. In 2002, this deduction is claimed on line 26. **The expenses must be incurred in connection with enrollment at an institution of higher (post-secondary) education.** Like the Hope and Lifetime Learning credits, the expenses must be in connection with an academic term starting in the tax year or in the first three months of the following tax year. The deduction must be **reduced** by:

- excludable interest from higher education savings bonds,
- excludable distributions from I.R.C. §529 qualified tuition plans,
- excludable distributions from Coverdell ESAs,
- non-taxable scholarships, or
- other educational assistance payments excludable from gross income.

A taxpayer **cannot** claim the new expense deduction and a Hope or Lifetime Learning credit in the **same year** for the **same student**. Therefore, additional tax planning will be necessary when 2002 returns are prepared to determine which option produces the most tax savings. **Married taxpayers who file separate returns cannot claim the deduction.**

Maximum deduction. For the **2002 and 2003** tax years, the **maximum** deduction is **$3,000**. For the **2004 and 2005** tax years, the maximum deduction is **either $4,000 or $2,000, depending on the taxpayer's modified AGI.**

Income Limits for 2002 and 2003 Tax Years (Maximum Deduction Is $3,000)

Filing Status	Deduction Not Allowed if 2002 or 2003 Modified AGI Exceeds
1. Married, filing jointly (MFJ)	$130,000
2. Other than MFJ	65,000

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Income limits for 2004 and 2005 tax years (maximum deduction is either $4,000 or $2,000 depending upon modified AGI)

Filing Status	$4,000 Deduction Allowed if Modified AGI Does Not Exceed:	$2,000 Deduction Allowed if Modified AGI Is Between:
1. MFJ	$130,000	$130,001 and $160,000
2. Other than MFJ	65,000	65,001 and 80,000

For the **2004 and 2005** tax years, **no deduction** is allowed to:

- MFJ taxpayers with modified AGIs that exceed $160,000, or
- other taxpayers with modified AGIs that exceed $80,000

Example 21. Orville is single. He paid $5,000 of college tuition and fees in **each** of the years 2002 through 2005. His modified AGI is **$60,000** in each year. His deduction for **2002 or 2003** is **$3,000**. Orville's partially completed 2002 Form 1040 is shown below. In **2004 or 2005**, his deduction increases to **$4,000**. Orville is entitled to the deductions **even if he does not itemize** his deductions on Schedule A.

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For Example 21

Form **1040** Department of the Treasury—Internal Revenue Service **U.S. Individual Income Tax Return** **2002** (99) IRS Use Only—Do not write or stamp in this space.

For the year Jan. 1–Dec. 31, 2002, or other tax year beginning , 2002, ending , 20 — OMB No. 1545-0074

Label (See instructions on page 19.) Use the IRS label. Otherwise, please print or type. LABEL HERE

Your first name and initial	Last name	Your social security number
Orville		333 33 3333
If a joint return, spouse's first name and initial	Last name	Spouse's social security number
Home address (number and street). If you have a P.O. box, see page 19.	Apt. no.	
City, town or post office, state, and ZIP code. If you have a foreign address, see page 19.		

Important! You **must** enter your SSN(s) above.

Presidential Election Campaign (See page 19.) **Note.** Checking "Yes" will not change your tax or reduce your refund. Do you, or your spouse if filing a joint return, want $3 to go to this fund? ▶ — You ☐ Yes ☐ No — Spouse ☐ Yes ☐ No

Filing Status Check only one box.

1 ☐ Single
2 ☐ Married filing jointly (even if only one had income)
3 ☐ Married filing separately. Enter spouse's SSN above and full name here. ▶
4 ☐ Head of household (with qualifying person). (See page 19.) If the qualifying person is a child but not your dependent, enter this child's name here. ▶
5 ☐ Qualifying widow(er) with dependent child (year spouse died ▶). (See page 19.)

Exemptions

6a ☑ **Yourself.** If your parent (or someone else) can claim you as a dependent on his or her tax return, **do not** check box 6a
b ☐ **Spouse**
c **Dependents:**

(1) First name / Last name	(2) Dependent's social security number	(3) Dependent's relationship to you	(4) ✓ if qualifying child for child tax credit (see page 20)
			☐
			☐
			☐
			☐

If more than five dependents, see page 20.

d Total number of exemptions claimed

No. of boxes checked on 6a and 6b: 1
No. of children on 6c who: • lived with you • did not live with you due to divorce or separation (see page 20): 1
Dependents on 6c not entered above:
Add numbers on lines above ▶: 1

Income

Attach Forms W-2 and W-2G here. Also attach Form(s) 1099-R if tax was withheld.

If you did not get a W-2, see page 21.

Enclose, but do not attach, any payment. Also, please use Form 1040-V.

7	Wages, salaries, tips, etc. Attach Form(s) W-2	7	45,000
8a	**Taxable** interest. Attach Schedule B if required	8a	5,000
b	**Tax-exempt** interest. **Do not** include on line 8a (8b)		
9	Ordinary dividends. Attach Schedule B if required	9	1,000
10	Taxable refunds, credits, or offsets of state and local income taxes (see page 22)	10	
11	Alimony received	11	
12	Business income or (loss). Attach Schedule C or C-EZ	12	
13	Capital gain or (loss). Attach Schedule D if required. If not required, check here ▶ ☐	13	(3,000)
14	Other gains or (losses). Attach Form 4797	14	
15a	IRA distributions (15a) b Taxable amount (see page 23)	15b	
16a	Pensions and annuities (16a) b Taxable amount (see page 23)	16b	
17	Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E	17	12,000
18	Farm income or (loss). Attach Schedule F	18	
19	Unemployment compensation	19	
20a	Social security benefits (20a) b Taxable amount (see page 25)	20b	
21	Other income. List type and amount (see page 27)	21	
22	Add the amounts in the far right column for lines 7 through 21. This is your **total income** ▶	22	60,000

Adjusted Gross Income

23	Educator expenses (see page xx)	23	
24	IRA deduction (see page 27)	24	3,000
25	Student loan interest deduction (see page 28)	25	
26	Tuition and fees deduction (see page XX)	26	3,000
27	Archer MSA deduction. Attach Form 8853	27	
28	Moving expenses. Attach Form 3903	28	
29	One-half of self-employment tax. Attach Schedule SE	29	
30	Self-employed health insurance deduction (see page 30)	30	
31	Self-employed SEP, SIMPLE, and qualified plans	31	
32	Penalty on early withdrawal of savings	32	
33a	Alimony paid b Recipient's SSN ▶	33a	
34	Add lines 23 through 33a	34	6,000
35	Subtract line 34 from line 22. This is your **adjusted gross income** ▶	35	54,000

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Note. Modified AGI is determined without regard to: 1) the Education expenses deduction on line 26 above, and 2) the IRA deduction.

Draft as of 8/14/2002

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Example 22. Assume the same facts as **Example 20**, except Orville's modified AGI in each year is $70,000. His deduction for **2002 or 2003** is zero. In **2004 or 2005**, his deduction is $2,000.

Example 23. Assume the same facts as **Example 20**, except Orville received a scholarship for $1,000 and withdrew $1,500 from an I.R.C. §529 qualified tuition program in each year. His qualifying expenses each year are reduced to $2,500 ($5,000 – $1,000 – $1,500). Therefore, his higher education expense deduction for the tax years 2002 through 2005 is $2,500.

The deduction is **not** allowed:

- if the taxpayer omits the name and taxpayer identification number of the individual for whom the qualified expenses are incurred;
- for any expense for which a deduction is allowed under any other provision of the Code; or
- to any individual to who can be claimed as a dependent on another taxpayer's return.

STUDENT LOAN INTEREST DEDUCTION — I.R.C. §221

PRIOR LAW INFORMATION

Qualified higher education student loan interest is deducted as an adjustment in arriving at adjusted gross income (I.R.C. §221). This provision was enhanced by the 2001 Act. The original provisions in the Taxpayer Relief Act of 1997 allowed for a deduction of $1,000 in 1998, $1,500 in 1999, $2,000 in 2000, and $2,500 for the tax years 2001 and later. Under prior law, interest could only be deducted in the **first 60 months** of the loan beginning when interest payments were required to begin. Voluntary interest payments were **not** deductible under prior law.

Important changes for 2002. This 60-month limitation and the voluntary interest restriction are **eliminated** by the 2001 Act. In addition, the modified AGI levels at which the deduction is reduced or eliminated (the phase-out range) are **increased**. This is explained later.

Example 24. Pete took out a student loan when he started college in 1991. The loan required him to begin making payments after his graduation in 1995. He could **not** deduct any interest payments in **1995, 1996, or 1997** because I.R.C. §221 was not yet enacted. Interest in **1998 and 1999** would be deductible. Interest payments in **2000 and 2001** would **not** be deductible because the 60-month limitation under prior law prohibited the deduction. However, interest paid in 2002 will again be deductible due to the repeal of the 60-month limitation.

Qualified Education Loans. A qualified education loan is indebtedness paid during the year by a taxpayer solely to pay qualified **higher education expenses** that are:

- incurred on behalf of a **student** who is the **taxpayer**, the taxpayer's **spouse**, or a **dependent** of the taxpayer at the time the indebtedness is incurred;
- paid within a reasonable time before or after the indebtedness is incurred (generally, within 60 days before or after the academic term begins or ends);
- attributable to an academic period when the student is an eligible student (degree candidate carrying at least a half-time workload);
- not paid on a loan from a related party such as a parent or grandparent, child or grandchild, spouse, brother or sister, half-brother or half-sister; or
- not paid on a loan from a qualified employer plan such as an I.R.C. §401(k) plan.

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Note. The Internal Revenue Service Restructuring and Reform Act of 1998 added the provision that the loan must be used solely for qualified education expenses. Consequently, mixed-use loans do not qualify for the interest deduction.

Loan origination fees and capitalized interest from prior periods will qualify if paid during the tax year. Qualified higher education expenses are defined **more broadly** for purposes of qualified student loan interest than for other education provisions. The cost of attendance includes transportation, miscellaneous necessary expenses, books, supplies, and room and board as well as tuition and fees.

A student is no longer required to waive the tax-free treatment for distributions from a Coverdell ESA in order to claim education credits during the same year. In order to avoid application of the credits, he/she must elect not to claim the credits for qualified tuition and related expenses paid during the year.

LIMITATIONS

Adjusted Gross Income Phase-out. Under **prior law**, the deduction was phased out ratably for taxpayers with modified adjusted gross income between $40,000 and $55,000 ($60,000 and $75,000 for married individuals who file a joint return). **For 2002 returns the range of the phase-out is increased to modified AGIs between $50,000 to $65,000 for unmarried taxpayers and between $100,000 to $130,000 for married taxpayers filing a joint return.**

Excerpt from IRS Pub. 970, page 19, *Tax Benefits for Higher Education.*

2002 Phase-out Ranges

IF Your Filing Status Is...	AND Your Modified AGI Is...	THEN Your Student Loan Interest Deduction Is...
Single, Head of Household, or Qualifying Widow	Not more than $50,000	Not affected by the phase-out.
	More than $50,000, but less than $65,000	Reduced because of phase-out.
	$65,000 or more	Eliminated by the phase-out.
Married, filing joint return	Not more than $100,000	Not affected by the phase-out.
	More than $100,000, but less than $130,000	Reduced because of phase-out.
	$130,000 or more	Eliminated by the phase-out.

Example 25. Quincy paid $2,800 in qualified student loan interest in **2002**. He is single, and his total income (line 22 of Form 1040) is $54,500. He made a $2,000 contribution to his IRA in 2002. The tentative student loan interest deduction of $2,500 is **reduced** by the phase-out rules. The 2002 Student Loan Interest Deduction Worksheet in the 2002 Form 1040 instructions, shown on the next page, computes Quincy's deduction of $2,082 on the next page.

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For Example 25

Student Loan Interest Deduction Worksheet—Line 25 of the 2002 Form 1040 *Keep for Your Records*

Before you begin:

- √ Complete Form 1040, lines 27 through 33a, if they apply to you.
- √ Figure any amount to be entered on the dotted line next to line 34 (see page XX).
- √ See the instructions for line 25 that begin on page XX.
- √ Be sure you have read the **Exception** on page XX to see if you can use this worksheet instead of Pub. 970 to figure your deduction.

1. Enter the total interest you paid in 2002 on qualified student loans (defined above).			1. 2,800
2. Enter the **smaller** of line 1 or $2,500			2. 2,500
3. Enter the amount from Form 1040, line 22	3. 54,500		
4. Enter the total of the amounts from Form 1040, line 24, lines 27 through 33a, plus any amount you entered on the dotted line next to line 34	4. 2,000		
5. Subtract line 4 from line 3	5. 52,500		
6. Enter the amount shown below for your filing status. • Single, head of household, or qualifying widow(er)Ñ $50,000 • Married filing jointlyÑ $100,000	6. 50,000		
7. Is the amount on line 5 more than the amount on line 6? ☐ **No.** Skip lines 7 and 8, enter -0- on line 9, and go to line 10. ☒ **Yes.** Subtract line 6 from line 5	7. 2,500		
8. Divide line 7 by $15,000. Enter the result as a decimal (rounded to at least three places). Do not enter more than Ò1.000Ó			8. .167
9. Multiply line 2 by line 8			9. 418
10. **Student loan interest deduction.** Subtract line 9 from line 2. Enter the result here and on Form 1040, line 25. **Do not** include this amount in figuring any other deduction on your return (such as on Schedule A, C, E, etc.)			10. 2,082

Draft

Dependents. A taxpayer **cannot** claim the deduction for a taxable year in which he/she is **claimed as a dependent** on another taxpayer's return. Therefore, families should plan to either have the parents borrow the education funds in their name, or to ensure that the student be independent of the parents when the interest is paid. Interest can be deducted only by the taxpayer who is obligated to make the interest payments.

Example 26. Julia paid $1,000 of interest on her student loans in 2002. Only Julia is required to make the payments. Her parents properly claim her as a dependent on their 2002 income tax return. Therefore, neither Julia nor her parents can deduct the $1,000 of student loan interest on their respective 2002 income tax returns.

Note. See **Chapter 13: Practitioner Q and A,** for more information in cases where the parent, rather than the dependent student, borrows the college funds.

If the taxpayer is married at the end of the tax year, he/she **must file a joint return** to claim the student loan interest deduction.

WITHDRAWALS FROM TRADITIONAL OR ROTH IRAs

GENERAL PROVISIONS

Beginning in 1998, taxpayers can withdraw money from an IRA (traditional or Roth) without paying the 10% premature distribution penalty if, for the year of withdrawal, the money is used to pay qualified higher educational expenses of :

- the taxpayer,
- the taxpayer's spouse, or
- any child or grandchild of the taxpayer or the taxpayer's spouse.

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Qualified educational expenses include tuition, fees, books, supplies, and equipment required for enrollment or attendance at an educational institution. Certain room and board expenses are also qualified educational expenses if the student is enrolled on at least a half-time basis.

LIMITATIONS

Qualified educational expenses must be **reduced** by any scholarship or other payment (other than a gift or inheritance) that is excluded from gross income by any provision in the Internal Revenue Code.

Examples.

1. A scholarship that is excluded under I.R.C. §117.
2. Any employer educational assistance excluded under I.R.C. §127.

In addition, any tax-free withdrawals from Coverdell ESAs reduce qualified higher education expenses. However, expenses are **not reduced** if paid with the taxpayer's earnings, or by loans or gifts received.

Many taxpayers misunderstand this provision. **The IRA withdrawal is not excluded from income when used for qualifying educational expenses.** Therefore, this provision is of no tax benefit to taxpayers who have attained age 59½.

> **Note.** Distributions from a 5-year old Roth IRA are first treated as a return of the taxpayer's nondeductible investment, hence nontaxable up to that amount.

The penalty exception is limited to IRAs. It does not apply to employer plans. Taxpayers who take a distribution from an I.R.C. §401(k) plan must pay both the income tax and the premature distribution penalty, unless they meet some other exception under I.R.C. §72.

EMPLOYER-PROVIDED EDUCATIONAL ASSISTANCE — I.R.C. §127

Educational assistance benefits provided by an employer are tax-free, up to $5,250 each year. The benefits of I.R.C. §127 have been available for many years. Congress has extended the provisions of I.R.C. §127 many times (even retroactively), and finally made it permanent in the 2001 Act.

The tax-free status of the payments applies only to education expenses of the employee. The exclusion does **not** apply to other members of the employee's family.

Payments made by a self-employed individual for him/herself qualify. Also, payments for the educational expenses of a 5% or more stockholder qualify, as long as the educational expenses for them do not exceed 5% of the total amounts paid or incurred.

Tax-free educational assistance benefits include payments by an employer for tuition, fees and similar expenses, books, supplies, and equipment. Under prior law, the payments could be excluded only for undergraduate level courses. Beginning in 2002, payments can also be excluded for graduate courses. The employer payments are not limited to work-related courses.

Neither a deduction nor an education credit (Hope or Lifetime Learning) can be claimed for any expenses for which the taxpayer received tax-free educational assistance benefits.

EDUCATION SAVINGS BOND PROGRAM — I.R.C. §135

Generally, tax must be paid on the interest earned on U.S. savings bonds. If the accrued interest is not included in income in the years it is earned, it is included in the year in which the bonds are cashed in. I.R.C. §135 allows for certain interest from savings bonds to be excluded from income.

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Interest received on the redemption of qualified U.S. savings bonds may be excluded from income if the taxpayer pays qualified higher educational expenses during the redemption year. **The exclusion is computed on Form 8815.** A qualified U.S. savings bond is a series EE bond issued after 1989 or a series I bond. The bond must be issued either in the name of the taxpayer or in the names of the taxpayer and his or her spouse as co-owners. The taxpayer must be at least 24 years old before the bond's issue date.

Qualified higher education expenses include the following items paid for the taxpayer, the taxpayer's spouse, or a dependent for whom the taxpayer claims an exemption:

- Tuition and fees required to enroll at or attend an eligible educational institution (Qualified expenses do **not** include expenses for room and board or for courses involving sports, games, or hobbies that are not part of a degree program.)
- Contributions to a qualified state tuition program
- Contributions to a Coverdell ESA

Qualified higher educational expenses must be **reduced** by the amount of any of the following benefits the student received:

A. Tax-free scholarships

B. Tax-free withdrawals from a Coverdell ESA

C. Any nontaxable payments (other than gifts, bequests, or inheritances) received for educational expenses or for attending an eligible educational institution, such as:

1. Veterans' educational assistance benefits.

2. Benefits under a qualified state tuition program.

3. Tax-free employer-provided educational assistance.

4. Any expenses used in figuring the Hope and Lifetime Learning credits.

AMOUNT EXCLUDABLE

If the total proceeds (interest and principal) from U.S. savings bonds redeemed during the year do not exceed the taxpayer's qualified higher educational expenses for the year, the interest is excludable. The exclusion amount is computed on Form 8815. If the total proceeds are more than the educational expenses, the taxpayer can exclude only part of the interest.

- The interest exclusion is phased out if the taxpayer's 2002 modified AGI is between $57,600 and $72,600 (between $86,400 and $116,400 for joint returns). The exclusion amount from Form 8815 is reported on Schedule B (Form 1040) or Schedule 1 (Form 1040A) and reduces taxable interest. Any amounts excluded must be subtracted from qualified educational expenses to compute the Hope or Lifetime Learning credits.

See pages 159-166 in the *2001 Farm Income Tax Workbook* for extensive coverage of this topic, including completed forms and schedules. This complete explanation shows that in most cases, the most tax savings are achieved by:

- claiming the Hope or Lifetime Learning credits **first** on **Form 8863, and**
- reporting any **remaining** tuition and fees on **line 2, Form 8815.**

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Form **8815**

Department of the Treasury
Internal Revenue Service (99)

Exclusion of Interest From Series EE and I U.S. Savings Bonds Issued After 1989

(For Filers With Qualified Higher Education Expenses)

▶ **Attach to Form 1040 or Form 1040A.**

OMB No. 1545-1173

2002

Attachment Sequence No. **57**

Name(s) shown on return

Your social security number

1	(a) Name of person (you, your spouse, or your dependent) who was enrolled at or attended an eligible educational institution	(b) Name and address of eligible educational institution

If you need more space, attach a statement.

2	Enter the total qualified higher education expenses you paid in 2002 for the person(s) listed in column (a) of line 1. See the instructions to find out which expenses qualify	2	
3	Enter the total of any nontaxable educational benefits (such as nontaxable scholarship or fellowship grants) received for 2002 for the person(s) listed in column (a) of line 1 (see instructions)	3	
4	Subtract line 3 from line 2. If zero or less, **stop.** You **cannot** take the exclusion	4	
5	Enter the total proceeds (principal and interest) from all series EE and I U.S. savings bonds **issued after 1989** that you **cashed during 2002**	5	
6	Enter the interest included on line 5 (see instructions)	6	
7	If line 4 is equal to or more than line 5, enter "1.000." If line 4 is less than line 5, divide line 4 by line 5. Enter the result as a decimal (rounded to at least three places)	7	× .
8	Multiply line 6 by line 7	8	
9	Enter your modified adjusted gross income (see instructions) **Note:** *If line 9 is $72,600 or more if single or head of household, or $116,400 or more if married filing jointly or qualifying widow(er),* ***stop.*** *You* ***cannot*** *take the exclusion.*	9	
10	Enter: $57,600 if single or head of household; $86,400 if married filing jointly or qualifying widow(er)	10	
11	Subtract line 10 from line 9. If zero or less, skip line 12, enter -0- on line 13, and go to line 14	11	
12	Divide line 11 by: $15,000 if single or head of household; $30,000 if married filing jointly or qualifying widow(er). Enter the result as a decimal (rounded to at least three places)	12	× .
13	Multiply line 8 by line 12	13	
14	**Excludable savings bond interest.** Subtract line 13 from line 8. Enter the result here and on Schedule B (Form 1040), line 3, or Schedule 1 (Form 1040A), line 3, whichever applies ▶	14	

Draft as of 6/20/2002

General Instructions

Section references are to the Internal Revenue Code.

Purpose of Form

If you cashed series EE or I U.S. savings bonds in 2002 that were issued after 1989, you may be able to exclude from your income part or all of the interest on those bonds. Use this form to figure the amount of any interest you may exclude.

Who May Take the Exclusion

You may take the exclusion if **all four** of the following apply.

1. You cashed qualified U.S. savings bonds in 2002 that were issued after 1989.

2. You paid qualified higher education expenses in 2002 for yourself, your spouse, or your dependents.

3. Your filing status is any status **except** married filing separately.

4. Your modified AGI (adjusted gross income) is less than: $72,600 if single or head of household; $116,400 if married filing jointly or qualifying widow(er). See the instructions for line 9 to figure your modified AGI.

U.S. Savings Bonds That Qualify for Exclusion

To qualify for the exclusion, the bonds must be series EE or I U.S. savings bonds issued after 1989 in your name, or, if you are married, they may be issued in your name and your spouse's name. Also, you must have been age 24 or older before the bonds were issued. A bond bought by a parent and issued in the name of his or her child under age 24 does not qualify for the exclusion by the parent or child.

Recordkeeping Requirements

Keep the following records to verify interest you exclude.

- Bills, receipts, canceled checks, or other documents showing you paid qualified higher education expenses in 2002.
- A written record of each post-1989 series EE or I bond that you cash. Your record must include the serial number, issue date, face value, and total redemption proceeds (principal and interest) of each bond. You may use **Form 8818,** Optional Form To Record Redemption of Series EE and I U.S. Savings Bonds Issued After 1989.

For Paperwork Reduction Act Notice, see back of form. Cat. No. 10822S Form **8815** (2002)

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