Chapter 6: Education Tax Incentives

Maximizing Education Tax Incentives 207
The Hope and Lifetime Learning Credits 207
Tuition and Fees Deduction 218
Section 529 Plans 221
Account Owners.. 222
Beneficiary... 223
Contributions Are Gifts.................................. 223
Types of §529 Plans 223
Evaluating a §529 Plan.................................... 227
Impact on Financial Aid................................. 227
Establishing a §529 Plan for a Grandchild..... 229
New Regulations Forthcoming 229
More Information on §529 Plans 231
Gift Tax Issues 231
Higher-Education Reporting Forms....................... 232
Background 232
Form 1098-T... 232
U.S. Savings Bonds.. 236
Interest-Income Exclusion 236
Education Loans.. 239
Overview.. 239
Home-Equity Indebtedness............................. 241
Federal Student-Loan Programs.................... 242

Corrections were made to this workbook through January of 2009. No subsequent modifications were made.

Income tax law contains numerous provisions providing tax incentives for higher-education expenses. These incentives come in the form of both credits and deductions. While there are requirements common to all these tax incentives, there are also some unique requirements, certain limitations, and restrictions. In order to properly advise clients, tax practitioners must understand each of these various tax incentives and their unique requirements and limitations.

Often, the exact same educational expense qualifies the taxpayer for several different tax incentives. However, tax law clearly states there is no double dipping. It is up to the tax professional to recommend the best tax treatment for each client's individual situation.

IRS Pub. 970, *Tax Benefits for Higher Education*, is an excellent resource.

MAXIMIZING EDUCATION TAX INCENTIVES

THE HOPE AND LIFETIME LEARNING CREDITS

For 2008, the **Hope Scholarship** tax credit is a nonrefundable credit of up to $1,800 per eligible student per year. This credit is only available for the **first two years** of postsecondary education. The credit equals 100% of the first $1,200 of qualifying educational expenses and 50% of the next $1,200 of qualifying educational expenses per eligible student. The maximum credit per student is $1,800.[1]

The **lifetime learning** tax credit is a nonrefundable credit of up to $2,000 per taxpayer per year. The credit is calculated as 20% of the first $10,000 of qualifying educational expenses, resulting in a maximum credit of $2,000 per year. The lifetime learning credit is allowed for **all years** of postsecondary education, including graduate and professional school expenses.

1. IRC §25A(b)(1)

Eligible Students

For the **Hope credit,** a student is considered an eligible student if she meets all the following requirements:

- The student did not claim the Hope credit in any two earlier tax years.
- The student is enrolled in the first two years of postsecondary education. **Years** in this context refers to the class standing of the student per the educational institution. If the student is a freshman in her fourth year at UCLA, she is still enrolled in one of her first two years of postsecondary education. The student's class standing at the beginning of the year is used for purposes of this requirement.
- The student is enrolled at least half-time in a degree or credential program for at least one academic period during the year.
- The student is free of any federal or state felony conviction for possessing or distributing a controlled substance.

For the **lifetime learning credit,** a student is considered eligible if:

- The student is enrolled in one or more courses at an eligible educational institution.
- The courses taken are part of a postsecondary degree program or taken to acquire or improve job skills.

> **Note.** For the **lifetime learning credit,** the student **does not** need to be enrolled at least half-time. The student is eligible for the credit for any year in which higher-education courses are taken, not just the first two years.

The following taxpayers **cannot claim** the Hope or lifetime learning tax credits:

- Married filing separately taxpayers
- Taxpayers listed as a dependent on another person's tax return
- Taxpayers filing as single, head of household (HoH), or qualifying widow(er) (QW) with modified adjusted gross income (MAGI) of $58,000; **or** MFJ taxpayers with MAGI of $116,000 or more for 2008
- Taxpayers who are nonresident aliens and who did not elect to be treated as resident aliens

> **Note.** Taxpayers cannot claim more than one credit or deduction for the same qualified expenses.

Comparison of 2008 Education Credits[2]

Hope Credit	Lifetime Learning Credit
Up to $1,800 credit per **eligible student**	Up to $2,000 credit per **return**
Available **ONLY** until the first 2 years of post-secondary education are completed	Available for all years of postsecondary education and for courses to acquire or improve job skills
Available **ONLY** for 2 years per eligible student	Available for an unlimited number of years
Student must be pursuing an undergraduate degree or other recognized education credential	Student does not need to be pursuing a degree or other recognized education credential
Student must be enrolled at least half time for at least one academic period beginning during the year	Available for one or more courses
No felony drug conviction on student's record	Felony drug conviction rule does not apply

Eligible Educational Institution

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

Qualified Expenses

Qualified higher-education expenses (QHEE) for both the Hope and the lifetime learning credits are tuition and related expenses paid on behalf of the taxpayer, the taxpayer's spouse, or the taxpayer's dependent for whom an exemption is claimed.[3] Fees and expenses for books, supplies, and equipment (such as a notebook computer), are included as qualified tuition and related expenses only if they must be paid to the educational institution **as a condition of enrollment or attendance.**

Room and board, insurance, medical fees, transportation, and personal expenses are **not** considered QHEE. This is true even if these expenses must be paid as a condition of enrollment or attendance. Educational expenses do not include expenses relating to sports, games, or hobbies unless such activities are part of the student's degree program.[4]

2. IRS Pub. 970, *Tax Benefits for Education* (2007)

3. IRC §25A(f)(1)

4. IRC §25A(f)(1)(B)

QHEE must be reduced by all of the following tax-free benefits to arrive at **adjusted qualified education expenses (AQEE):**

- Tax-free scholarships and fellowships[5]
- Expenses used to compute tax-free withdrawals from Coverdell Education Savings Accounts (ESAs)[6]
- Expenses used to compute tax-free withdrawals from §529 plans[7]
- Expenses used to compute the interest exclusion from U.S. savings bonds[8]
- Any other nontaxable payments received for educational expenses such as the following:
    - Veterans' educational-assistance benefits[9]
    - Qualified tuition reductions
    - Employer-provided educational assistance[10]

Educational expenses qualify in the tax year in which they are paid. Payments must be for education that begins during the tax year or in the first three months of the next tax year. [11]

> **Example 1.** On December 1, 2007, Elizabeth receives her tuition bill for the spring semester, which begins January 15, 2008. Elizabeth pays the tuition bill in December. Therefore, she can claim the Hope credit on her 2007 return. If Elizabeth waits until January to pay the tuition bill, she cannot claim the credit until 2008.

Educational expenses paid with loan proceeds qualify in the tax year the **expenses are paid,** not in the year the loan is repaid. Loan proceeds disbursed directly to an education institution are treated as paid on the disbursement date.[12]

The treatment of educational expenses paid through a third-party installment payment company (IPC) depends upon whether the third-party IPC is considered the taxpayer's agent or the educational institution's agent. When the third-party IPC is the taxpayer's agent, the taxpayer is treated as paying the educational expenses on the date the IPC pays the educational institution. If the third-party IPC is the educational institution's agent, the taxpayer is treated as paying the educational expenses on the date the taxpayer pays the IPC.

> **Note.** For purposes of the Hope credit, all AQEE incurred during the calendar year qualify for the credit even if the student finishes her second year of postsecondary education during the year. For example, if in the spring of 2008, a student was considered a sophomore by her college, and in the fall of 2008 she was considered a junior, the tuition and fees for both semesters could be used for the Hope credit.

5. IRC §25A(g)(2)(A)
6. IRC §530(d)(2)(C)
7. IRC §530(d)(2)(C)
8. IRC §135(c)(2)(A)
9. Treas. Reg. §1.25A-5(c)(ii)
10. Treas. Reg. §1.25A-5(c)(iii)
11. IRC §25A(g)(4)
12. Treas. Reg. §1.25A-5(e)(3)

Income Limitations

Both the Hope and the lifetime learning tax credits are phased out for higher-income taxpayers based on MAGI. MAGI is AGI with the following additions:[13]

- Foreign earned income and housing exclusions and deductions
- Exclusion of income from American Samoa or Puerto Rico

2008 Hope and Lifetime Learning Tax Credits Income Limitations

Filing Status	2008 Phaseout Range
Married filing jointly (MFJ)	$96,000–116,000
Single, head of household (HoH), qualifying widow(er) (QW)	48,000– 58,000
Married filing separately (MFS)	N/A

Calculating the Credits

Form 8863, *Education Credits (Hope and Lifetime Learning Credits)*, is used to compute both the Hope and the lifetime learning credits. Based on the taxpayer's AQEE, Form 8863, Parts I and II calculate the **tentative credits** for the Hope and lifetime learning credit, respectively. Part III calculates the taxpayer's **allowable education credit** based on applicable income limitations.

Which Credit to Claim?

Even if a student qualifies for claiming the Hope tax credit, it is not necessarily best to claim it. The lifetime learning credit currently is larger than the Hope credit. Parents paying substantial tuition may find it more advantageous to utilize the lifetime learning credit for all four years of college.

Example 2. Rachael is a freshman at a small private college where qualifying tuition and fees are $10,000 per year. Rachael's parents, Bob and Judy, need to determine which credit is more tax advantageous for their situation. Their MAGI is $90,000. Their total tax before credits is $10,129. If they claim the Hope credit, their maximum credit is $1,800. However, if they elect to claim the lifetime learning credit instead, their maximum credit is $2,000.

Amount of AQEE	$10,000
Hope Credit	
Smaller of AQEE or $2,400	$ 2,400
Smaller of AQEE or $1,200	1,200
Total	$ 3,600
	× 50%
	$ 1,800
Lifetime Learning Credit	
Qualified expense	$10,000
Lesser of qualified expense or $10,000	10,000
	× 20%
	$ 2,000

13. IRC §25A(d)(3)

For Example 2

Form **8863** — Department of the Treasury, Internal Revenue Service (99)

Education Credits (Hope and Lifetime Learning Credits)

▶ See instructions to find out if you are eligible to take the credits.
▶ Attach to Form 1040 or Form 1040A.

OMB No. 1545-0074 — **2008** — Attachment Sequence No. **50**

Name(s) shown on return	Your social security number
Bob and Judy	777 88 9999

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

Part I **Hope Credit. Caution:** *You* ***cannot*** *take the Hope credit for 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 (see instructions). **Do not** enter more than $2,400 for each student.	**(d)** Enter the **smaller** of the amount in column (c) or $1,200	**(e)** Add column (c) and column (d)	**(f)** Enter one-half of the amount in column (e)

2	**Tentative Hope credit.** Add the amounts on line 1, column (f). If you are taking the lifetime learning credit for another student, go to Part II; otherwise, go to Part III . . . . ▶	2	

Part II **Lifetime Learning Credit**

3	**(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)
	Rachael		999 88 7777	10,000

4	Add the amounts on line 3, column (c), and enter the total	4	10,000
5	Enter the **smaller** of line 4 or $10,000	5	10,000
6	**Tentative lifetime learning credit.** Multiply line 5 by 20% (.20) and go to Part III	6	2,000

Part III **Allowable Education Credits**

7	Tentative education credits. Add lines 2 and 6			7	2,000
8	Enter: $116,000 if married filing jointly; $58,000 if single, head of household, or qualifying widow(er)	8	116,000		
9	Enter the amount from Form 1040, line 38,* or Form 1040A, line 22 .	9	90,000		
10	Subtract line 9 from line 8. If zero or less, **stop;** you cannot take any education credits	10	26,000		
11	Enter: $20,000 if married filing jointly; $10,000 if single, head of household, or qualifying widow(er)	11	20,000		
12	If line 10 is equal to or more than line 11, enter the amount from line 7 on line 13 and go to line 14. If line 10 is less than line 11, divide line 10 by line 11. Enter the result as a decimal (rounded to at least three places)			12	× .
13	Multiply line 7 by line 12 . . . . ▶			13	2,000
14	Enter the amount from Form 1040, line 44, or Form 1040A, line 28 (minus any alternative minimum tax included on Form 1040A, line 28)			14	10,129
15	Enter the total, if any, of your credits from Form 1040, lines 47 and 48, or Form 1040A, lines 29 and 30	15	0		
16	1040 filers: Enter the amount from Form 6251, line 31 (see instructions) 1040A filers: Enter the amount, if any, from the Alternative Minimum Tax Worksheet, line 20 (see instructions)	16			
17	Add lines 15 and 16			17	
18	Subtract line 17 from line 14. If zero or less, **stop**. You cannot take any education credits . ▶			18	10,129
19	**Education credits.** Enter the smaller of line 13 or line 18 here and on Form 1040, line 49, or Form 1040A, line 31 . . . . ▶			19	2,000

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

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Coordination of Credits

The Hope and lifetime learning credits cannot be claimed simultaneously for the same student. However, planning when the credits will be claimed can result in increased tax savings.

Usually the academic school year begins in the fall. Consequently, the traditional student's first two years of postsecondary education span three calendar tax years. The Hope credit can be claimed only in two of those three calendar years.

Example 3. Ryan is enrolled in a 2-year program. His tuition is $5,000 per semester. On a calendar-year basis, he pays $5,000 tuition in Year 1, $10,000 tuition in Year 2, and $5,000 tuition in Year 3.

Ryan claims the Hope credit for the first two calendar years and the lifetime learning credit for the last year. His education credits are $1,800 for Year 1, $1,800 for Year 2, and $1,000 for Year 3. This totals $4,600 of credits over the three years.

However, if Ryan claimed the Hope credit in Year 1 and Year 3, and the lifetime learning credit in Year 2, his total credits **increase to $5,600 over the three years** ($1,800 for Year 1, $2,000 for Year 2, and $1,800 for Year 3).

	Year 1	Year 2	Year 3
Amount of AQEE	$5,000	$10,000	$5,000
Hope Credit			
Smaller of AQEE or $2,400	$2,400	$ 2,400	$ 2,400
Smaller of AQEE or $1,200	1,200	1,200	1,200
Total	$3,600	$ 3,600	$3,600
	× 50%	× 50%	× 50%
	$1,800	$ 1,800	**$ 1,800**
Lifetime Learning Credit			
AQEE	$5,000	$10,000	$5,000
Lesser of AQEE or $10,000	5,000	10,000	5,000
	× 20%	× 20%	× 20%
	$1,000	**$ 2,000**	$1,000
Highest Credit			
Year 1	$1,800		
Year 2	2,000		
Year 3	1,800		
Total credits	$5,600		

Note. Because the Hope credit is indexed for inflation, the actual credit in Years 2 and 3 could be different than shown.

Five Years of Credits for Four Years of School

Academic years overlap calendar years. Therefore, it is possible to obtain five years of tax credits for only four years of school. Most colleges give students the option of paying for the spring semester in either December or January. When the option to pay in January is available, tax planning can result in tax savings.

Example 4. Juanita's tuition is $5,000 per semester. Each year, it is due in August and in December or January of the following year.

Juanita pays the $5,000 tuition every August and December. She can claim four years of lifetime learning credits totaling $8,000 ($2,000 per year).

Tuition Paid in August and December

	Year 1	Year 2	Year 3	Year 4	Year 5
Amount of AQEE	$10,000	$10,000	$10,000	$10,000	$0
Hope Credit					
Smaller of AQEE or $2,400	$ 2,400	$ 2,400	$ 2,400	N/A	0
Smaller of AQEE or $1,200	1,200	1,200	1,200	N/A	
Total	$ 3,600	$ 3,600	$ 3,600	N/A	
	× 50%	× 50%	× 50%	× 50%	
	$ 1,800	$ 1,800	$ 1,800	N/A	
Lifetime Learning Credit					
AQEE	$10,000	$10,000	$10,000	$10,000	
Lesser of AQEE or $10,000	10,000	10,000	10,000	10,000	
	× 20%	× 20%	× 20%	× 20%	
	$ 2,000	**$ 2,000**	**$ 2,000**	**$ 2,000**	
Highest Credit					
Year 1	$ 2,000				
Year 2	2,000				
Year 3	2,000				
Year 4	2,000				
Total credits	$ 8,000				

Example 5. Juanita from **Example 4** meets with her accountant in November of Year 1, a month before she plans to pay her spring tuition bill. Her accountant advises her to delay paying her spring tuition bill until January of the following year. With this simple adjustment, her total education credits over the next five years will be $8,800 ($1,800 Hope credit for Year 1, $2,000 lifetime learning credits for Years 2, 3, and 4, and $1,000 lifetime learning credit for Year 5).

Tuition Paid in August and January

	Year 1	Year 2	Year 3	Year 4	Year 5
Amount of AQEE	$5,000	$10,000	$10,000	$10,000	$5,000
Hope Credit					
Smaller of AQEE or $2,400	$2,400	$ 2,400	$ 2,400	N/A	N/A
Smaller of AQEE or $1,200	1,200	1,200	1,200	N/A	N/A
Total	$ 3,600	$ 3,600	$ 3,600	N/A	N/A
	× 50%	× 50%	× 50%	× 50%	× 50%
	$1,800	$ 1,800	$ 1,800	N/A	N/A
Lifetime Learning Credit					
AQEE	$5,000	$10,000	$10,000	$10,000	$5,000
Lesser of AQEE or $10,000	5,000	10,000	10,000	10,000	5,000
	× 20%	× 20%	× 20%	× 20%	× 20%
	$1,000	**$ 2,000**	**$ 2,000**	**$ 2,000**	**$1,000**
Highest Credit					
Year 1	$1,800				
Year 2	2,000				
Year 3	2,000				
Year 4	2,000				
Year 5	1,000				
Total credits	$8,800				

Example 6. Ken and Lisa have MAGI of $90,000 and total tax before credits of $9,800 in 2008. They paid tuition of $500 in 2006 and $1000 in 2007 for their dependent daughter, Judy, to attend the local junior college. They claimed the Hope credit for 100% of the tuition each year.

Judy completes her sophomore year in May of 2008 and begins her junior year at Bradlee University in September. In January of 2008, Ken pays $500 for Judy's tuition at the junior college. In September, Ken pays $4,500 in QHEE to Bradlee. Their total AQEE in 2008 is $5,000.

Judy is still an eligible student for the Hope credit in 2008, because she was a sophomore during part of the tax year. The tentative Hope credit for 2008 is $1,800 as shown on the following Form 8863. The tentative lifetime learning credit for 2008 is $1,000 ($5,000 × 20%). For 2008, the Hope credit is worth $800 more than the lifetime credit. However, they have already claimed the Hope credit for two prior tax years.

If they had claimed the lifetime learning credit in 2006, the credit would have been $100 ($500 × 20%) instead of the $500 received for the Hope credit. They can amend the 2006 return to elect the lifetime learning credit in lieu of the Hope credit. If they do, they will have to repay the $400 difference plus interest. However, this will allow them to claim the Hope credit in 2008, thereby realizing $800 more in credits for 2008.

For Example 6

Form **8863** | **Education Credits (Hope and Lifetime Learning Credits)** | OMB No. 1545-0074

Department of the Treasury
Internal Revenue Service (99)

▶ See instructions to find out if you are eligible to take the credits.
▶ Attach to Form 1040 or Form 1040A.

2008
Attachment Sequence No. **50**

Name(s) shown on return	Your social security number
Ken & Lisa	111 12 2323

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

Part I **Hope Credit. Caution:** *You* ***cannot*** *take the Hope credit for 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 (see instructions). **Do not** enter more than $2,400 for each student.	(d) Enter the **smaller** of the amount in column (c) or $1,200	(e) Add column (c) and column (d)	(f) Enter one-half of the amount in column (e)
	Judy	666 54 3333	2,400	1,200	3,600	1,800

2	**Tentative Hope credit.** Add the amounts on line 1, column (f). If you are taking the lifetime learning credit for another student, go to Part II; otherwise, go to Part III ▶	2	1,800

Part II **Lifetime Learning Credit**

3	(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)

4	Add the amounts on line 3, column (c), and enter the total	4	
5	Enter the **smaller** of line 4 or $10,000	5	
6	**Tentative lifetime learning credit.** Multiply line 5 by 20% (.20) and go to Part III	6	

Part III **Allowable Education Credits**

7	Tentative education credits. Add lines 2 and 6			7	1,800
8	Enter: $116,000 if married filing jointly; $58,000 if single, head of household, or qualifying widow(er)	8	116,000		
9	Enter the amount from Form 1040, line 38,* or Form 1040A, line 22	9	90,000		
10	Subtract line 9 from line 8. If zero or less, **stop;** you cannot take any education credits	10	26,000		
11	Enter: $20,000 if married filing jointly; $10,000 if single, head of household, or qualifying widow(er)	11	20,000		
12	If line 10 is equal to or more than line 11, enter the amount from line 7 on line 13 and go to line 14. If line 10 is less than line 11, divide line 10 by line 11. Enter the result as a decimal (rounded to at least three places)			12	× .
13	Multiply line 7 by line 12 ▶			13	1,800
14	Enter the amount from Form 1040, line 44, or Form 1040A, line 28 (minus any alternative minimum tax included on Form 1040A, line 28)			14	9,800
15	Enter the total, if any, of your credits from Form 1040, lines 47 and 48, or Form 1040A, lines 29 and 30	15			
16	1040 filers: Enter the amount from Form 6251, line 31 (see instructions) 1040A filers: Enter the amount, if any, from the Alternative Minimum Tax Worksheet, line 20 (see instructions)	16			
17	Add lines 15 and 16			17	
18	Subtract line 17 from line 14. If zero or less, **stop**. You cannot take any education credits ▶			18	9,800
19	**Education credits.** Enter the smaller of line 13 or line 18 here and on Form 1040, line 49, or Form 1040A, line 31 ▶			19	1,800

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

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Electing Not to Claim the Credits

A taxpayer may choose not to claim the Hope tax credit or the lifetime learning tax credit.[14] When the taxpayer waives the dependency exemption for a dependent student, the student may elect to **claim the credit** on her own return.[15] The student may not claim the dependency exemption, however.

> **Note.** The strategy described above allows a parent whose income is above the phaseout range to shift the tax credit benefits to the child. This strategy is only effective when the child has sufficient tax liability to utilize the credit.

Repaying the Credit

An amended return is not required if a taxpayer receives a refund of tuition or fees after filing his return. The taxpayer must increase his tax for the following year by the amount of the excess credit he claimed in the prior year. This amount is computed by reducing qualified expenses on which the credit was claimed by the refund, and then recomputing the credit by using the redetermined qualified expenses. That amount is included as an additional tax in the year the refund is received with the notation "ECR" on the appropriate line of Form 1040 or 1040A.[16]

Divorced and Unmarried Couples

When a taxpayer claims an exemption on his return for an eligible student, then any educational expenses paid for the student are treated as if paid by the taxpayer.[17] For divorced and unmarried couples, whoever claims the exemption for the student can claim the credit, regardless of who paid the tuition expenses.

Example 7. Cecylia's parents, Alan and Marie, are divorced. Cecylia lives with Marie, who claims Cecylia as a dependent according to the divorce decree. The divorce decree also stipulates that Alan pays all Cecylia's college expenses.

Alan pays all Cecylia's educational expenses for the year. Those expenses are treated as if paid by Cecylia. Cecylia is properly claimed as a dependent by Marie. Even though Marie did not pay any of the educational expenses, Marie can claim either the Hope or lifetime learning credit on those expenses.

> **Note.** The dependency exemption for divorced or unmarried couples is based on the rules for qualifying children. See pages 36–39 in the 2006 *University of Illinois Federal Tax Workbook* for a comprehensive review of the uniform definition of a child rules for divorced or unmarried couples. See pages 532–534 in the 2007 *University of Illinois Federal Tax Workbook* for related rulings and cases. See also the "Dependency Issues" section of Chapter 15, "Rulings and Cases" of this book for current-year developments.

Any educational expenses paid by a third party (such as a grandparent, former spouse, or other relative) are treated as paid by the student. When the taxpayer claims an exemption on his return for an eligible student, any educational expenses paid by the student are treated as paid by the taxpayer.[18]

Example 8. In 2008, Grandma Mosses paid all the educational expenses for the year for her grandson, Tom. Tom is claimed as a dependent on his mother's tax return. The educational expenses paid by Grandma are treated as paid by Tom. In turn, those educational expenses are treated as paid by Tom's mother. She may claim either the Hope or lifetime learning credit on those amounts.

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14. IRC §25A(e)
15. Ltr. Rul. 200236001 (December 18, 2001)
16. Form 1040A Instructions
17. Treas. Reg. §1.25A-5(a)
18. Treas. Reg. §1.25A-5(b)(1)

TUITION AND FEES DEDUCTION

The tuition and fees deduction can reduce income subject to tax by up to $4,000. This deduction was introduced in the Economic Growth and Tax Relief and Reconciliation Act of 2001.

> **Note.** Originally, the effective date for this deduction was after December 31, 2001, and before January 1, 2006. The deduction was extended through December 31, 2007. It is expected to be extended again for 2008.

This tax incentive provides an above-the-line deduction for certain QHEE. This deduction is claimed by filing Form 8917, *Tuition and Fees Deduction*. This deduction is **not allowed** if the taxpayer claims either the Hope or lifetime learning credits for the same student.

Income Limitations

This deduction has higher income limitations than the Hope or lifetime learning credits.[19]

2008 Tuition and Fees Deduction Income Limitations

Years	Maximum Deduction	Filing Status	AGI Limitations
2008	$4,000	MFJ	$130,000 or less
		Single, HoH, QW	65,000 or less
		MFS	N/A
2008	$2,000	MFJ	$130,001–160,000
		Single, HoH, QW	65,001–80,000
		MFS	N/A

> **Note.** These are the presumed limitations if Congress extends the tuition and fees deduction. Current Code does not index these limitations for inflation.

Qualified Expenses

For this deduction, QHEE includes tuition and related expenses paid on behalf of the taxpayer, the taxpayer's spouse, or the taxpayer's dependent for whom an exemption is claimed.[20] Fees and expenses for books, supplies, and equipment are included as qualified tuition and related expenses only if the fees must be paid to the educational institution as **a condition of enrollment or attendance.** If a student withdraws from school, any portion of the tuition and fees that are not refunded can be claimed.

As with the Hope and lifetime learning credits, QHEE must be reduced by these tax-free benefits to arrive at AQEE:

- Tax-free scholarships and fellowships[21]
- Expenses used to compute tax-free withdrawals from Coverdell ESAs[22]
- The excludable **income** portion of a distribution from a §529 plan[23]

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19. IRC §222(b)
20. IRC §222(d)(1)
21. IRS Pub. 970, *Tax Benefits for Education* (2007)
22. IRC §222(c)(2)(B)
23. Ibid

- Expenses used to compute tax-free interest from U.S. savings bonds[24]
- Any other nontaxable payments received for educational expenses such as:
  - Veterans' educational-assistance benefits,
  - Qualified tuition reductions, or
  - Employer-provided educational assistance.

Example 9. Elizabeth pays $1,000 of qualified tuition and related expenses during the year. She also received a $1,000 tax-free distribution from a Coverdell ESA. The Coverdell distribution includes $800 of contributions and $200 of earnings.

Elizabeth **cannot deduct any part of the $1,000 of tuition expenses she paid.** This is because QHEE is reduced by expenses used to compute the **tax-free portion of a Coverdell ESA distribution.** When Coverdell funds are used for education expenses, they are distributed tax free.

Example 10. Use the same facts as **Example 9,** except the distribution was from a §529 plan. The §529 plan distribution includes $800 of contributions and $200 of earnings.

Elizabeth can deduct $800 of the AQEE as a tuition and fees deduction. For the tuition and fee deduction, qualified expenses only have to be reduced by the **income portion** of a §529 plan distribution.

Eligibility to Claim the Deduction

Eligible Student. An eligible student is enrolled in one or more courses at an eligible educational institution. Unlike the Hope credit requirements, the eligible student does not have to be enrolled in school at least half time.

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

Eligibility for Deduction. Eligibility for the deduction depends upon several factors:

- Who paid the eligible expenses?
- Is the eligible student claimed as a dependent?
- Is the eligible student not claimed as a dependent, although the taxpayer has the right to claim the student as a dependent?

When the taxpayer claims an exemption on his return for an eligible student, then the tuition and fees deduction is calculated **using only those educational expenses paid by the taxpayer and spouse.** If the taxpayer claims an exemption on his return for an eligible student and the **student** paid the tuition expenses himself, no one is allowed to claim the deduction.

Example 11. Mike's qualifying tuition and fees were $5,000 for the year. Mike paid $2,000 of his tuition and the remaining $3,000 was paid by his mother, Bonnie. When Bonnie files her return claiming Mike as a dependent, she can only claim the $3,000 she paid when calculating her tuition and fees deduction. Mike is not eligible to claim the tuition and fees deduction because he was claimed as a dependent by Bonnie.

Any educational expenses paid by a **third party** (such as a grandparent, former spouse, or other relative) are **treated as paid by the student**. If the taxpayer **claims an exemption** on his return for the eligible student, then no one is allowed to claim the tuition and fees deduction.

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24. Ibid

Example 12. Use the same facts as **Example 11,** except Mike's qualifying tuition and fees were paid by his grandfather. When Bonnie files her return claiming Mike as a dependent, she is not eligible to claim the tuition and fees deduction. Additionally, neither Mike nor his grandfather is eligible to claim the tuition and fees deduction.

Note. Mike's grandfather could provide a gift of tuition and fees amount to Bonnie, who then pays the expense for Mike. In this situation, Bonnie could claim the tuition and fees deduction.

If the taxpayer does not claim an exemption for the student, but **is eligible** to do so, then no one is allowed to claim the tuition and fees deduction. This applies whether the expenses are paid by the taxpayer or the student.

Example 13. Use the same facts as **Example 12,** except Bonnie does not claim Mike as dependent although she is eligible to do so. Neither Bonnie, Mike, nor his grandfather is eligible to claim the tuition and fees deduction.

When the taxpayer **does not claim an exemption** for the student and is **not eligible** to claim such an exemption, any educational expenses paid by the taxpayer are treated as a gift to the student. The student can then use his educational expenses to calculate the tuition and fees deduction.

Example 14. Use the same facts as **Example 12,** except Mike is not eligible to be claimed as a dependent on someone else's return. His MAGI for 2007 is $26,000 (from Form 1040, line 22). Mike's income tax liability before credits is $2,200. Mike can use his grandfather's gift of the $5,000 of tuition and fees to calculate his tuition and fees deduction. His Form 8917 follows:

Form **8917**
Department of the Treasury
Internal Revenue Service

Tuition and Fees Deduction
▶ See Instructions.
▶ Attach to Form 1040 or Form 1040A.

OMB No. 1545-0074
2007
Attachment Sequence No. **63**

Name(s) shown on return: **Mike** — Your social security number: **321 98 7654**

CAUTION *You **cannot** take both an education credit from Form 8863 and the tuition and fees deduction from this form for the **same student** in the same year.*

Before you begin: ✓ To see if you qualify for this deduction, see *Who Can Take the Deduction* in the instructions below.
✓ If you file Form 1040, use the instructions for line 36 to figure any write-in adjustments to be entered on the dotted line next to Form 1040, line 36.

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 (see instructions)
	Mike		**321 98 7654**	**5,000**

2	Add the amounts on line 1, column (c), and enter the total			2	**5,000**
3	Enter the amount from Form 1040, line 22, or Form 1040A, line 15	3	**26,000**		
4	Enter the total from either: • Form 1040, lines 23 through 33, plus any write-in adjustments entered on the dotted line next to Form 1040, line 36, **or** • Form 1040A, lines 16 through 18	4	**0**		
5	Subtract line 4 from line 3.* If the result is more than $80,000 ($160,000 if married filing jointly) STOP You cannot take the deduction for tuition and fees			5	**26,000**
6	**Tuition and fees deduction.** Is the amount on line 5 more than $65,000 ($130,000 if married filing jointly)? ☐ **Yes.** Enter the **smaller** of line 2, or $2,000. Also enter this amount on Form 1040, line 34, or Form 1040A, line 19. ☑ **No.** Enter the **smaller** of line 2, or $4,000. Also enter this amount on Form 1040, line 34, or Form 1040A, line 19.			6	**4,000**

Note. Mike should compare all applicable education credits and deductions to optimize his education benefit.

Other Requirements. The tuition and fees deduction is **not allowed if:**

- The taxpayer is **claimed as a dependent** on someone else's return,
- The taxpayer files **married filing separately,**[25]
- The taxpayer or spouse is a **nonresident alien and did not elect to be treated as a resident alien** for tax purposes,[26]
- The tuition and fees are being deducted under any other provision of the tax law,[27] or
- The taxpayer is **claiming a Hope or lifetime learning tax credit for the same student.**[28]

Claiming the Deduction

The tuition and fees deduction is claimed on Form 8917, *Tuition and Fees Deduction,* which is attached to the taxpayer's Form 1040 or Form 1040A.

As with the Hope and lifetime learning credits, the taxpayer should utilize the incentive that provides the most advantageous tax treatment. This choice becomes especially interesting when the taxpayer has more than one dependent college student. Claiming a tuition and fees deduction for one of the dependent students frequently reduces the taxpayer's AGI. This results in a larger Hope or lifetime learning tax credit for the other student(s).

> **Note.** Other considerations for opting to take the tuition and fees deduction instead of an education credit include reducing state income tax for states that factor federal AGI into the computation of taxable income, increasing itemized deductions that are based on a percentage of AGI, and lowering AGI in order to avoid or reduce detrimental phaseouts.

Reporting Refunds of Tuition and Fees Already Claimed

Occasionally, a taxpayer receives tax-free educational assistance or a refund of tuition and fees expenses after filing his return. Taxpayers may have to repay or recapture the deduction when this occurs. Repayment is accomplished by reporting the amount refunded or the tax-free educational assistance received when filing the current year Form 1040. The amount is reported on the line for other income. Form 1040A cannot be used in this situation.

SECTION 529 PLANS

Section 529 is the IRS Code section that grants special tax status to qualified educational savings programs. Section 529 plans, also called **qualified tuition programs (QTP),** are established and maintained by either a state government or a private educational institution.

> **Note.** Many investment firms and mutual fund companies advertise that they offer §529 plans. These types of organizations cannot sponsor §529 plans. However, states or private educational institutions frequently hire investment firms or mutual fund companies to manage their §529 plans.

25. IRC §222(d)(3)(4)
26. IRC §222(d)(3)(5)
27. IRC §222(c)(1)
28. IRC §222(c)(2)(A)

In order for a tuition program to be considered a §529 plan, amounts contributed must be held in a qualified trust, and the entity must receive a ruling or determination from the IRS that indicates the programs satisfies the applicable requirements. There are several requirements that must be met in order for a plan to be considered a §529 plan. These are as follows:

- Contributions to the plan may be made in cash, or by check, money order, credit card, or electronic transfer from bank or investment accounts.[29]
- The plan must provide separate accounting for each designated beneficiary.[30]
- Neither the account owner nor the beneficiary is allowed to direct the investment of the account.[31] Usually account owners are permitted to choose between broad-based investment strategies and to change investment strategies once per year.
- The §529 plan cannot be pledged or used as security for a loan.[32]
- The plan cannot allow contributions greater than what is reasonably expected to be necessary for the beneficiary's higher-education expenses.[33] When the value of the account grows beyond the account balance limitation, no further contributions to the plan are allowed.[34]

Note. Account owners can open §529 plans in other states if the account balance limitation is an issue.

Unlike other education tax benefits, there are **no income limitations with §529 plans.**

ACCOUNT OWNERS

The account owner has complete ownership of the §529 plan account. The account owner:

- Decides when and if distributions are taken,
- Can change beneficiaries at any time and for any reason (with certain tax consequences), and
- May distribute funds at any time and for any reason (with certain tax consequences).[35]

Under federal tax law, account owners can be individuals, corporations, partnerships, trusts, estates, §501(c)(3) organizations, Uniform Gifts to Minors Act (UGMA) accounts, and Uniform Transfers to Minors Act (UTMA) accounts. Federal law has no income, age, or residency restrictions on who can own a §529 plan account.

Note. Some states may define **account owner** differently than federal law does, and may have age or residency restrictions.

Federal law does not allow joint ownership of §529 plans. Married couples can establish two separate §529 plan accounts, or title the account in one spouse's name with the other spouse listed as contingent or successor account owner.

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29. IRC §529(b)(2)
30. IRC §529(b)(3)
31. IRC §529(b)(4)
32. IRC §529(b)(5)
33. IRC §529(b)(6)
34. Prop. Treas. Reg. §1.529-2(i)(2)
35. Prop. Treas. Reg. §1.529-1(c)

BENEFICIARY

When a §529 plan is established, **a single designated beneficiary must be identified.**[36] When the account owner wants to benefit more than one individual, a separate account must be established for each designated beneficiary.

CONTRIBUTIONS ARE GIFTS

Contributions are treated as completed gifts that are eligible for the $12,000 federal annual gift tax exclusion.[37] However, states may set limits on plan contributions.

Donors may elect to prorate their contribution over five years so they do not exceed the annual gift tax exclusion. This effectively allows contributions totaling five times the annual gift tax exclusion ($60,000 for individuals and $120,000 for split gifts) without gift tax consequences.[38]

When the donor dies during the 5-year period, the donor's estate includes in the gift tax return only that portion of the contributions allocable to years after the donor's death.[39]

Example 15. In 2007, Grandma Jones contributes $60,000 to a §529 plan naming her grandson, Rob, as beneficiary. She elects to prorate this contribution over five years on her 2007 gift tax return.

In 2008, Grandma gives Rob $2,000 cash. This is a taxable gift because her $12,000 annual exclusion was used by the §529 plan contribution.

Section 529 plans allow beneficiary changes to another qualifying member of the family without penalty. However, some plans impose an administrative fee. There are no federal income tax consequences on beneficiary changes to qualified family members. There is no gift tax consequence on beneficiary changes to qualified family members unless the new beneficiary is in a younger generation than the prior beneficiary.[40]

Example 16. Grandma Jones' §529 plan has an account balance of $70,000, which includes $60,000 of contributions and $10,000 of earnings. In 2008, Grandma decides to change the account's beneficiary. Her grandson Rob was arrested for DUI and Grandma wants nothing to do with him. She names her granddaughter, Alison, as beneficiary. There are no income or gift tax consequences on this beneficiary change.

If the new beneficiary is in **a younger generation,** the change in beneficiary designation is **considered a gift** from the prior beneficiary to the new beneficiary. This gift is eligible for the special 5-year proration.[41]

Example 17. Use the same facts as **Example 16,** except Grandma changes the beneficiary to her **great-grandson,** David. There are no income tax consequences on this beneficiary change.

However, this beneficiary change is considered a gift from Rob to David. This gift is eligible for the special 5-year proration. Accordingly, Rob is deemed to have made a $10,000 taxable gift in 2008 to David. The total gift is $70,000 ($60,000 contributions + $10,000 earnings). The 5-year proration is $60,000 ($12,000 × 5). The taxable gift is deemed to be $10,000 ($70,000 – $60,000).

TYPES OF §529 PLANS

There are two types of §529 plans: **prepaid tuition programs** and **qualified educational savings accounts.** State-established programs can provide either a prepaid tuition program or a higher-education savings account. Educational institution-established programs can provide only prepaid tuition programs.

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36. IRC §529(e)(1)
37. IRC §529(c)(2)(A)(i)
38. IRC §529(c)(2)(B)
39. IRC §529(c)(4)(C)
40. IRC §529(c)(5)(B)
41. Ibid

Prepaid Tuition Programs

Under a prepaid tuition program, the donor purchases credits or semesters of tuition for the account beneficiary. The donor is able to lock in public university tuition rates at any of the state's participating colleges or universities by paying today for a future education. The programs are typically guaranteed to rise in value at the same rate as college tuition. Consequently, if a donor purchases a plan for one year of tuition, that plan will always be worth one year of tuition.

> **Caution.** Unfortunately, purchasing a prepaid tuition program does not guarantee the child will be accepted by any of the participating colleges or universities. The terms and conditions of these programs vary greatly by state.

Higher-Education Savings Accounts

Higher-education savings accounts are considered QTPs. Under a higher-education savings account, the donor saves funds for the educational expenses of the account beneficiary. There is no guarantee the funds will rise in value at the same rate as college tuition. Most higher-education savings accounts can be used for all college expenses, not just tuition and fees. As with prepaid tuition programs, the terms, conditions, and limits vary greatly by state.

Two tax consequences may arise from distributions from a QTP:

1. **Taxable income** on the earnings included in the distributions when the distributions exceed the QHEE
2. A **10% penalty** on the earnings from a qualified distribution in excess of AQEE

Qualified Distributions. Qualified distributions from a §529 plan are distributions spent on QHEE at eligible institutions.[42] Generally, there is no federal income tax on qualified distributions. State income tax treatment of qualified distributions varies.

QHEE consists of the following:

- Tuition, fees, books, supplies, and equipment required by the educational institution[43]
- Room and board if the student is enrolled at least half time. Room and board expenses are the greater of:
  - The allowance for room and board that the educational institution used in the cost of attendance for federal financial aid purposes, and
  - The actual amount paid to the eligible educational institution for room and board.[44]
- Special needs services required by special needs students[45]

QHEE **must be reduced** by all the following tax-free benefits to arrive at AQEE:

- Tax-free scholarships
- Other nontaxable payments received for educational expenses such as:
  - Veterans' educational assistance benefits,
  - Qualified tuition reductions, or
  - Employer-provided educational assistance.

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42. IRC §529(c)(3)(B)
43. IRC §529(e)(3)(A)(i)
44. IRC §529(e)(3)(B)
45. IRC §529(e)(3)(A)(ii)

Example 18. In 2008, Sally receives a distribution of $10,000 from a §529 plan. This distribution includes $8,000 of contributions and $2,000 of earnings.

Sally spends the distribution as follows: $6,000 tuition and fees, $3,000 room and board, and $1,000 books and required supplies. Therefore, there is no federal income tax on the distribution.

Nonqualified Distributions. A nonqualified distribution is any distribution that is not a qualifying distribution. The account owner pays tax on the earnings portion of the distribution and a 10% penalty.[46]

Example 19. Olivia opened a higher-education savings account many years ago with high hopes for her son, Tom. In 2008, Tom drops out of school. Olivia decides to take a $10,000 distribution from the savings account to pay for her kitchen remodeling because Tom did not need it for college expenses. This distribution includes $8,000 of contributions and $2,000 of earnings.

Olivia must report the $2,000 of earnings on her Form 1040, line 21 as "Other income." In addition, she will owe the 10% penalty of $200 when she files her federal return.

When a nonqualified distribution is due to the beneficiary's death or disability, or because the beneficiary received a scholarship, the earnings portion is still included in income. However, the 10% penalty tax does not apply.[47] If the distribution is greater than the amount of the QHEE, the penalty applies.

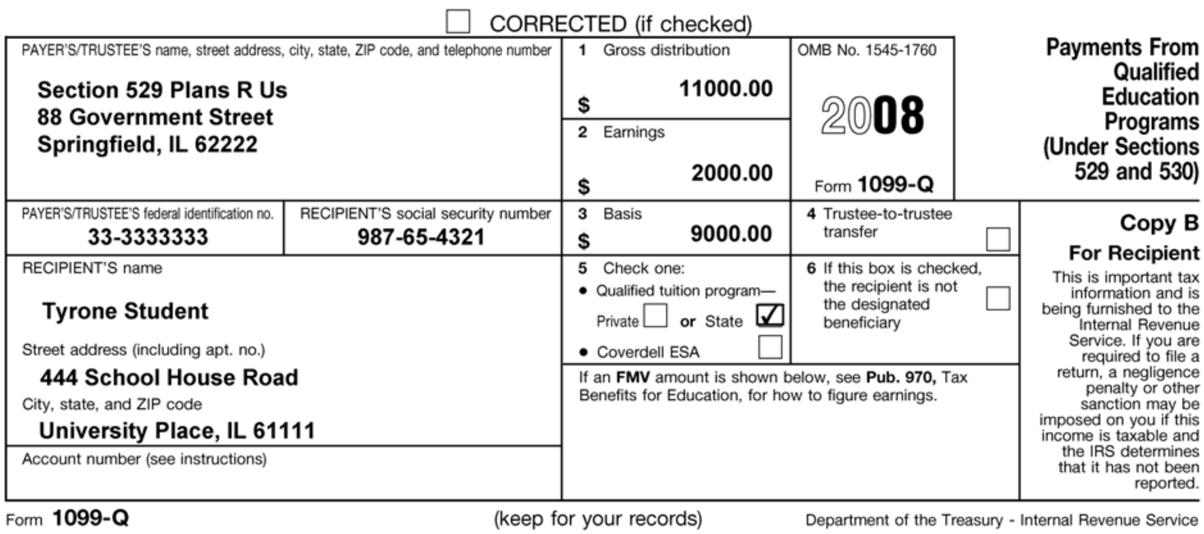
To calculate the taxable portion of a distribution, the following formula is used:

AQEE = QHEE − scholarships

Tax-free earnings amount = Earnings portion of distribution × (AQEE ÷ total distribution)

Taxable QTP = Earnings portion of distribution − tax-free earnings amount

Example 20. Tyrone receives a $6,000 scholarship after a distribution of $11,000 was taken from a §529 plan. Form 1099-Q, *Payments from Qualified Education Programs (under sections 529 and 530),* shows the distribution includes $9,000 of return of contributions and $2,000 of earnings (box 2).


☐ CORRECTED (if checked)

PAYER'S/TRUSTEE'S name, street address, city, state, ZIP code, and telephone number
Section 529 Plans R Us
88 Government Street
Springfield, IL 62222

1 Gross distribution $ 11000.00
2 Earnings $ 2000.00
OMB No. 1545-1760
2008
Form 1099-Q

Payments From Qualified Education Programs (Under Sections 529 and 530)

PAYER'S/TRUSTEE'S federal identification no. 33-3333333
RECIPIENT'S social security number 987-65-4321
3 Basis $ 9000.00
4 Trustee-to-trustee transfer ☐

Copy B
For Recipient

RECIPIENT'S name
Tyrone Student
Street address (including apt. no.)
444 School House Road
City, state, and ZIP code
University Place, IL 61111
Account number (see instructions)

5 Check one:
• Qualified tuition program—
Private ☐ or State ☑
• Coverdell ESA ☐
6 If this box is checked, the recipient is not the designated beneficiary ☐

If an **FMV** amount is shown below, see **Pub. 970,** Tax Benefits for Education, for how to figure earnings.

This is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if this income is taxable and the IRS determines that it has not been reported.

Form 1099-Q (keep for your records) Department of the Treasury - Internal Revenue Service

46. IRC §529(c)(3)(A)

47. IRC §529(c)(6)

Tyrone's QHEE for the year is \$11,000 (\$7,000 tuition + \$3,000 room and board + \$1,000 books and required supplies). However, Tyrone received a scholarship of \$6,000. Therefore, his AQEE is \$5,000.

AQEE = \$11,000 − \$6,000 = \$5,000

Tax-free earnings amount = \$2,000 × (\$5,000 ÷ \$11,000) = \$909

Taxable QTP = \$2,000 − \$909 = \$1,091

Because Tyrone received QTP distributions of \$11,000 and his QHEE was also \$11,000, the 10% penalty does not apply. However, Tyrone must include \$1,091 as taxable income on his Form 1040, line 21. If Tyrone's father, who is the account owner, received the \$6,000 excess distribution, the \$1,091 would be reported on the father's Form 1040.

Rollovers. A transfer from a §529 plan to another §529 plan for the benefit of the same beneficiary is considered a rollover rather than a distribution.[48] **The rollover treatment only applies to one transfer within any 12-month period for the same beneficiary.**[49]

Transfers or rollovers between plans can be accomplished in one of two ways:

1. A direct trustee to trustee transfer can be made.
2. A distribution can be taken from the plan followed by a contribution to another plan within 60 days.

For rollovers and beneficiary changes, a qualifying member of the family is an individual who has one of the following relationships to the current beneficiary:[50]

- Spouse
- Son, daughter, or descendant
- Stepson or stepdaughter
- Brother, sister, stepbrother, or stepsister
- Father, mother, or ancestor
- Niece or nephew
- Aunt or uncle
- Son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law
- Spouse of any of the relatives listed above
- First cousin

48. IRC §529(c)(3)(C)(i)
49. IRC §529(c)(3)(C)(iii)
50. IRC §529(e)(2)

EVALUATING A §529 PLAN

Many clients are turning to their tax preparers for suggestions and advice regarding §529 plans. In deciding which plan is best for a client, many factors, including the client's financial situation and the ages of her children, must be considered. Other considerations include the following:

- The plan offered by the state in which your client is a resident (Many states offer state income tax benefits for investing in their plan.)
- Plans offered by other states that do not have a residency requirement
- Obtaining the latest information for the plans you are considering (After adopting their initial plans, most states have made numerous changes to make their plans more attractive. Additionally, many plans have been updated to reflect the changes made by recent tax laws.)

Below are issues to consider when evaluating plans:

- Flexibility of contributions
- Maximum contributions
- Fees and administrative expenses
- Limitations on school choice
- Flexibility of use
- Transferability
- Potential return on investment
- State guarantees
- Penalties
- State tax benefits

IMPACT ON FINANCIAL AID

The Higher Education Reform Act of 2005 (HERA) attempted to provide equivalent treatment for financial aid purposes whenever a qualified education benefit (QEB) was used as a college savings vehicle. Section 529 plans are considered a QEB for financial aid purposes, if:

1. A dependent student is the owner of a §529 plan, then the plan is not considered an asset under the financial aid formula;
2. An independent student is the owner of a §529 plan, then the plan is considered an asset for financial aid purposes;
3. A parent is the owner of a §529 plan, then the plan is considered the parent's asset for financial aid purposes; or
4. A grandparent or other relative is the owner of a §529 plan, then the plan is not considered an asset under the financial aid formula.

Comparison of §529 Plans to Other College Funding Sources

	Income	Allowable Expenses	Control	Investment Choices	Other
§529 Plan	☺ Tax-free growth, totally tax free if used for QHEE	☹ QHEE only	☺ Account owner controls distributions	Limited by plan	Possible state income tax benefits
Coverdell ESA	☺ Tax-free growth, totally tax free if used for QHEE	☹ QHEE only	☺ Account owner controls distributions	☺ Unlimited	Can be used for pre-college education expenses
UGMA or UTMA Accounts	☹ Currently taxable	☺ Not limited to QHEE	☹ Child has full control at age of majority (18 or 21)	☺ Unlimited	Can be the owner of a §529 plan
U.S. Savings Bonds	Tax deferred growth, tax free if used for QHEE	☹ QHEE only	☺ Bond owner controls distributions	☹ Only Series EE and I U.S. savings bonds	☺ No state income taxes
Bank or Brokerage Account	☹ Currently taxable	☺ Not limited to QHEE	☺ Account owner controls distributions	☺ Unlimited depending upon account	
IRA	Tax-free growth	No 10% penalty if used for QHEE	☺ IRA owner controls distributions	Regular IRA investment limitations	☺ Use for retirement if not needed for college
Roth IRA	Tax-free growth, principal withdrawals tax free	No 10% penalty if used for QHEE	☺ IRA owner controls distributions	Regular IRA investment limitations	☺ Use for retirement if not needed for college
Life Insurance Products	Tax deferred growth, can borrow without tax	☺ Not limited to QHEE	☺ Owner controls distributions	Limited by plan	☹ Need to pay back loan

ESTABLISHING A §529 PLAN FOR A GRANDCHILD

Many grandparents want to help fund the college education of their grandchildren. This is particularly true if the grandparents have saved enough to ensure a comfortable retirement.

Before setting up a §529 plan for a grandchild, the taxpayer should compare the use of a §529 plan with alternative savings vehicles, considering any impact the savings vehicle may have on potential future financial aid. When a §529 plan is deemed the best choice, then several decisions should be made. These include:

- Determining when to establish the plan,
- Determining the type of plan to establish (prepaid tuition or higher-education savings accounts), and
- Determining who should be the account owner.

When to Establish the Plan. Grandparents need to decide if the plan should be established early, when the grandchild is still an infant, or later when it appears the grandchild may actually attend college. Obviously, the main advantage to establishing the plan when the grandchild is an infant is that the money has more time to grow. With a long-term investment horizon, even modest contributions can grow to significant amounts. The major disadvantage to establishing the plan early is not knowing whether the grandchild will attend college. Most grandparents want education savings spent only on education.

Should A Prepaid Tuition Plan or Higher-Education Savings Account Be Established? Because of the great flexibility offered, higher-education savings accounts are usually the best choice for plans established by grandparents. The plan beneficiary can be changed from one grandchild to another, if necessary. Beneficiary changes can occur without losing earnings.

The Account Owner. The three obvious choices are the grandparent, the parent, and the child/grandchild. There are tradeoffs to each choice:

- The §529 plan is not considered an asset for financial aid purposes if the account owner is either the grandparent or the child/grandchild. When financial aid is likely to be needed, the account owner probably should not be the parent.
- Control of the account is important to consider. When the account owner is the parent or grandparent, decisions about the use of the account falls to a (presumably) responsible adult.

In many cases, the grandparent is probably the best choice for account owner. However, this choice should be monitored in light of the probable forthcoming regulations.

> **Note.** Grandparents should always name a successor account owner.

NEW REGULATIONS FORTHCOMING

On March 3, 2008, the IRS announced that new proposed regulations are forthcoming.[51] These proposed regulations are designed to prevent potential abuse of §529 accounts, especially in the area of designated beneficiary changes and avoidance of transfer taxes.

The current law regarding the transfer tax treatment of §529 accounts is unclear, and in some situations imposes tax in a manner inconsistent with generally applicable transfer tax provisions of the Code. In addition, current law raises the potential for abuse of §529 accounts in certain situations.

Abuse may arise because of the opportunity to change designated beneficiaries (DB) without triggering transfer tax. For example, a taxpayer may establish and contribute to multiple accounts by taking advantage of the 5-year rule with different DBs, but with the intention to change the DBs to a single, common beneficiary and distributing the entire amount without further tax consequences.

51. IRS Ann. 2008-17, 2008-9 IRB 512

Example 21. Sara contributes $60,000 to 10 different §529 accounts, one for each of her grandchildren. At a later date, she changes the DB on each account to her son, thus transferring $600,000 to him without incurring gift tax. In addition to not paying gift tax, she has reduced her estate by $600,000.

Because the contributor to the account can also be the DB, some taxpayers have used the §529 account as a retirement account without incurring the restrictions and requirements of a qualified retirement account. In other cases, the contributor funds a §529 plan naming himself as the DB. This incurs no gift tax, and the DB is the same as the contributor. At a later date, another family member in an older generation is named as the DB. Under current law, the gift tax is avoided.

The notice of proposed rule-making:

1. Provides general **anti-abuse rules** that apply when a §529 account is established and used for avoiding or evading transfer tax, or used for purposes inconsistent with IRC §529,
2. Includes **rules related to the tax treatment** of contributions to QTP and its participants, particularly related to inconsistencies between IRC §529 and generally applicable income and transfer tax provisions of the Code, and
3. Includes **rules related to the function and operation** of §529 accounts.

Anti-Abuse Rules. The anti-abuse rules likely will deny favorable transfer tax treatment if contributions are intended or used for purposes other than providing the QHEE of the designated beneficiary. The rule will also focus on the actual source of the funds, the person who actually contributes cash to the account, and the person who receives the distribution from the account. The IRS intends to monitor transactions involving §529 accounts. The IRS may adopt rules that limit the circumstances under which a QTP may permit:

- Account owners to withdraw funds,
- A change in beneficiaries, and
- The account owner to name a different account owner.

Tax Treatment Rules. In order to assign the tax liability to an account owner, a change in a designated beneficiary that results in any tax will be treated as a deemed distribution to the account owner followed by a new gift. This will ensure the account owner is responsible for any gift or generation-skipping transfer tax when a change in beneficiary occurs.

Concerns about account owners withdrawing funds from §529 accounts for their own benefit will be addressed by rules such as limiting account owners to individuals, and making them liable for income tax on the entire amount of funds distributed for their own benefit. The IRS will provide special rules for corporations, partnerships, estates, trusts, and other entities that contribute funds to QTPs.

Currently §529 plans can be established by UGMA and UTMA accounts, which essentially means minor individuals are establishing plans for their own benefit. Contributions to §529 plans are considered completed gifts, and an individual cannot transfer property to himself. The IRS will continue to allow contributions to §529 accounts by minor individuals for their own benefit. However, special rules will apply in cases involving a change in designated beneficiaries. It is anticipated that the deemed distribution to the contributor will be treated as a rollover if the new designated beneficiary is a family member or former designated beneficiary.

The IRS proposes five rules regarding tax consequences arising from the death of a designated beneficiary. The rules address situations such as:

- No successor beneficiary was named,
- A successor beneficiary was named and is a member of the decedent's family,
- The entire §529 account is distributed to the decedent's estate, and
- The consequences of leaving funds in the account without naming a new designated beneficiary.

Function and Operation Rules. The IRS hopes to clarify the rules regarding electing to aggregate a contribution and report it over five years. The rules address which form to use to make the election, the election for contributions made by married couples, and treatment of contributions that exceed the annual gift tax exclusion but are not in excess of five times the exclusion.

The IRS will provide guidance on how to recognize a loss on a §529 account. The IRS proposes a rule that requires distributions made during a calendar year be used to pay QHEE during the same calendar year or by March 31 of the following calendar year in order for the distributions to be excluded from income.

The public was asked to send comments to the IRS regarding the proposed regulations by March 18, 2008.

Note. The proposed regulations may require some states and private educational institution to modify their plans in order to comply with the new regulations and remain QTPs.

MORE INFORMATION ON §529 PLANS

There is a tremendous amount of information about §529 plans on the Internet. One source is **www.savingforcollege.com.** This site compares the various state plans and answers many questions a taxpayer may have regarding the plans.

GIFT TAX ISSUES

Anyone wanting to assist a student with educational expenses can make a cash gift of up to $12,000 without incurring gift tax consequences. Cash gifts to a student for tuition or other expenses are considered annual gifts. They are part of the $12,000 annual gift tax exclusion.

Contributions made to Coverdell ESAs and §529 plans are also considered annual gifts and are part of the $12,000 annual gift tax exclusion.

Example 22. In 2008, Gramps gives $12,000 cash to his grandson, Ian. He also contributes $10,000 to the Illinois Bright Start College Savings Program naming Ian as the beneficiary. Gramps must file a gift tax return for 2008 reporting $22,000 of gifts to Ian, of which only $12,000 is eligible for the annual gift tax exclusion.

Gifts in excess of the $12,000 annual gift tax exclusion reduce both the taxpayer's $1 million lifetime gift exemption amount and estate exemption amount.

Any amount paid **directly** to an educational institution for **tuition** is excluded from the gift amount. This exclusion applies without regard to the amount of the tuition or the relationship between the donor and the donee. **The exclusion does not apply to amounts paid for books, supplies, room and board, or other expenses** that do not constitute direct tuition costs.[52]

Example 23. In 2008, Uncle Joe gives his nephew, David, $5,000 cash. He also pays $34,934 ($26,066 tuition and $8,868 room and board) directly to Harvard for David's education expenses. Uncle Joe must file a gift tax return reporting $1,868 of taxable gifts ($5,000 cash plus $8,868 room and board less $12,000 annual gift tax exclusion). **The tuition payment of $26,066 is excluded from his gifts.**

52. Treas. Reg. §25.2503-6

HIGHER-EDUCATION REPORTING FORMS

BACKGROUND

The Taxpayer Relief Act of 1997 added IRC §6050S to the Code. This stipulated that any eligible educational institution file information returns and furnish information statements to help taxpayers determine the amount of qualified tuition and related expenses that can be used to calculate an education credit.

The Restructuring and Reform Act of 1998 amended the Code to require institutions to report either the aggregate amounts received in a calendar year or report the amounts billed for qualified tuition and related expenses. Institutions are permitted to change their method of reporting from one calendar year to the next. Educational institutions must separately report adjustments, such as refunds, made during the calendar year. Institutions must also report scholarships and grants awarded and report if scholarships or grants were reduced from what was originally reported.[53]

In 2002, the IRS issued final regulations describing the reporting requirements for educational institutions.[54] Form 1098-T, *Tuition Statement*, was created to report information to the IRS and to the taxpayer.

FORM 1098-T

Educational institutions must send the student Form 1098-T, *Tuition Statement*, or an acceptable alternative by January 31 (February 2, 2009, for the 2008 forms). This form is required for students (exceptions listed below) who are considered enrolled in the school.

Although this form is intended to help taxpayers calculate their deduction or credit, in actuality it is quite confusing. The first problem is that the schools send the form to the student. When compiling the information needed to prepare income tax returns, most taxpayers mistakenly include this form with the student's tax information. However, the taxpayer **claiming the student as a dependent** needs this information for his return.

The second problem is that not all students receive the Form 1098-T. The educational institution is not required to furnish a Form 1098-T in the following situations:

- The student took courses for which no academic credit is offered.
- The student is a nonresident alien.
- The student's entire tuition is waived or paid with scholarships and grants.
- The student's tuition is paid under a formal billing arrangement between the educational institution and the student's employer or a governmental entity.

The third problem is that the financial information reported on the form is confusing and **often insufficient.**

53. Rev. Proc. 2005-50, 2005-32, IRB 272

54. TD 9029, 2003-1 CB 403

☐ CORRECTED

FILER'S name, street address, city, state, ZIP code, and telephone number		1 Payments received for qualified tuition and related expenses $ 2 Amounts billed for qualified tuition and related expenses $	OMB No. 1545-1574 2008 Form 1098-T	Tuition Statement
FILER'S federal identification no.	STUDENT'S social security number	3 If this box is checked, your educational institution has changed its reporting method for 2008 ☐		Copy B For Student
STUDENT'S name		4 Adjustments made for a prior year $	5 Scholarships or grants $	This is important tax information and is being furnished to the Internal Revenue Service.
Street address (including apt. no.) City, state, and ZIP code		6 Adjustments to scholarships or grants for a prior year $	7 Checked if the amount in box 1 or 2 includes amounts for an academic period beginning January - March 2009 ▶ ☐	
Service Provider/Acct. No. (see instr.)	8 Checked if at least half-time student ☐	9 Checked if a graduate student ☐	10 Ins. contract reimb./refund $	

Form 1098-T (keep for your records) Department of the Treasury - Internal Revenue Service

Box 1 — Payments Received. If the educational institution uses this method of reporting transactions, it shows total payments the educational institution received from any source during the year for qualified tuition and fees net of any reimbursements or refunds.

Box 2 — Payments Billed. If the educational institution uses this method of reporting transactions, it shows the net amount billed during the year for qualified tuition and fees.

The educational institution reports **either the payments they received** for qualifying tuition and fees in box 1 **or the amount they billed** for qualifying tuition and fees in box 2. However, the amounts in boxes 1 and 2 may be different than what was actually paid. The taxpayer's credit or deduction is computed using **the amounts actually paid during the tax year.** This information is best obtained from the detailed bills the student received from the educational institution, not from the Form 1098-T.

> **Example 24.** Sam attends Quincy College, where tuition and fees are $2,000 per semester. Quincy College bills Sam $2,000 in August 2008 for the fall semester, and $2,000 in December 2008 for the spring semester. Quincy College sends Sam a completed 2008 Form 1098-T showing $4,000 in **box 2** as amounts billed for qualified tuition and fees.
>
> Sam pays the tuition in the same months he was billed (August and December 2008). He computes his 2008 education deduction or credit on the entire $4,000 he paid in 2008.
>
> If Sam instead paid the tuition for the spring semester in January 2009, he computes his 2008 education deduction or credit on $2,000 only. This is the amount he paid in 2008. The $2,000 billed in December 2008 and paid in January 2009 will be used to compute his education deduction or credit for 2009.

Box 3 — Change of Reporting Method. This box is checked if the educational institution changed its method of reporting from the previous year.

> **Example 25.** Use the same facts as **Example 24.** Quincy College bills Sam $2,000 in August 2009 for the fall semester and $2,000 in December 2009 for the spring semester.
>
> Sam paid his August 2008 tuition in August 2008. He paid his Spring 2009 tuition in January 2009. He paid his Fall 2009 tuition in August 2009 and his Spring 2010 tuition in December 2009.
>
> Quincy College sends Sam a completed Form 1098-T for 2009 with **box 3** checked and the $6,000 payments **received** is reported in **box 1.**

Box 4 — Adjustments Made for Prior Year. This box shows any adjustments (such as refunds) made to amounts reported on a prior year's Form 1098-T.

A credit or deduction is not allowed for qualified expenses that are subsequently refunded. Excludable educational assistance received after a student has paid his tuition is treated as a refund. The taxpayer reduces his eligible expenses when a refund is received in the same year expenses are paid or in the following year **before his return is filed.**[55]

Example 26. In August 2008, Marcos pays $2,000 tuition and fees to the local community college to be a full-time student for the fall semester. Prior to beginning classes, he withdraws from several classes. This changes his status to three-fourths time. In January 2009, Marcos receives a refund of $500 from the college.

To compute his Hope tax credit for 2008, Marcos must reduce the $2,000 tuition paid by the $500 refund received. His net result is $1,500 of qualified education expenses for 2008, for a maximum credit of $1,350.

Marcos **decides to claim the tuition and fees deduction** rather than the Hope credit. He reduces the $2,000 tuition paid by the $500 refund received. His net result is $1,500 of qualified education expenses for 2008, for a maximum tuition and fees deduction of $1,500.

The 2008 Form 1098-T Marcos receives from the college should show $2,000 in box 1 (amount paid) **or** $1,500 in box 2 (net amount billed).

If the college reports amounts paid in box 1, then Marcos will also receive a 2009 Form 1098-T showing $500 in box 4.

An amended return is **not** required if a taxpayer receives a refund after filing his return. If the taxpayer claimed one of the education tax credits, he must increase his tax for the following year by the prior year's credit claimed attributable to the refund. This amount is computed by reducing qualified expenses on which the credit was claimed by the refund, and then recomputing the credit by using the redetermined qualified expenses. That amount is included as an additional tax in the year the refund is received with the notation "ECR."

Example 27. Use the same facts as **Example 26,** except Marcos does not receive the refund until May 2009. He timely filed his 2008 return, and **claimed a Hope tax credit** on the entire $2,000 tuition payment.

Hope credit as reported on Marcos' 2008 tax return	$1,600
Less: Hope credit as recomputed after refund	(1,350)
Additional tax reported on his 2009 Form 1040, with the notation "ECR"	$ 250

The 2008 Form 1098-T Marcos receives from the college should show $2,000 in box 1 (amount paid) **or** $1,500 in box 2 (net amount billed).

If the college reports amounts paid in box 1, then Marcos will also receive a 2009 Form 1098-T showing $500 in box 4.

If the taxpayer claimed the tuition and fees deduction and received a refund after his return is filed, he increases his income in the following year by the refunded amount to the extent that it reduced his tax. This amount is computed by reducing qualified expenses on which the original tuition and fees deduction was computed by the refund, and then recomputing the deduction using the redetermined qualified expenses. That amount is included as additional income on the "Other Income" line on Form 1040 in the year the refund is received.

Example 28. Use the same facts as **Example 27,** except Marcos claimed the tuition and fees deduction in 2008.

Tuition and fees deduction as reported on Marcos' 2008 tax return	$2,000
Less: tuition and fees deduction as recomputed after refund	(1,500)
Additional income reported on his 2009 Form 1040, line 21 — Other Income	$ 500

55. Treas. Reg. §1.25A-5(f)(1)

Box 5 — Scholarships and Grants. This box shows the total amount of scholarships and grants administered and processed by that educational institution. The amounts shown in box 1 or 2 may or may not need to be reduced by the amounts shown in box 5. Additionally, the amounts shown in box 1 or 2 may need to be reduced by scholarships and grants **not reported** in box 5.

When a scholarship or grant is used to pay tuition and fees, the taxpayer must reduce the amounts in box 1 or 2 by the portion so used. To the extent a scholarship or grant is used for expenses other than tuition or fees, that portion is taxable. Therefore, the amounts in box 1 or 2 are not reduced by that portion.

> **Example 29.** Shaneese, a degree candidate, paid $3,000 tuition and $5,000 room and board at City University. Shaneese was awarded a $2,000 scholarship. The terms of her scholarship allows it to be used to pay any of her college expenses.
>
> Shaneese receives a Form 1098-T from City University showing $3,000 in box 1 and $2,000 in box 5.
>
> Shaneese uses the scholarship to pay her tuition, which makes her scholarship tax free. She must reduce the $3,000 tuition by the $2,000 scholarship for a net of $1,000 tuition. She can claim an education deduction or credit for the $1,000 she paid.

> **Example 30.** Use the same facts as **Example 29,** except Shaneese uses the scholarship to pay her room and board. Her scholarship is taxable in this situation. The amount is reported as wages on Form 1040 with the notation "SCH."[56] Shaneese does not need to reduce the $3,000 tuition by the scholarship to calculate her education deduction or credit.

Box 6 — Adjustments for Scholarships and Grants for a Prior Year. This box shows the reduction in any scholarship or grant administered and processed by the educational institution that was reported on Form 1098-T in any prior year.

When this reduction changes the amount of income reported in the prior year because the scholarship or grant was taxable, the taxpayer can claim a current year deduction for the amount of the reduction.

If the reduction is $3,000 or less, the taxpayer claims the amount on Schedule A as a miscellaneous itemized deduction subject to the 2% of AGI limitation. There is no tax benefit if the taxpayer does not itemize or exceeds the 2% of AGI limitation.

> **Example 31.** Sanjay received a $15,000 taxable grant from Gator University in 2006. This amount was properly reported as a taxable scholarship on his 2006 return. Sanjay claimed the standard deduction and paid $658 of income tax on the grant. In 2007, the grant was reduced by $2,000. Because Sanjay does not itemize, he does not obtain any tax benefit.

For reductions greater than $3,000, the taxpayer has two options:

1. The taxpayer can claim a miscellaneous itemized deduction for the full amount of the repayment.
2. The taxpayer can claim a tax credit on the current year's return. The taxpayer recomputes tax for the prior year as if the income had not been reported. The credit is the difference between the actual tax in the prior year and the recomputed tax. This credit is claimed on the current year's Form 1040, line 69 (2008) with the notation "IRC 1341" next to the line.

> **Example 32.** Use the same facts as **Example 31,** except in 2007 the grant was reduced by $4,000. Sanjay has two options. Because he does not itemize, he chooses the tax credit option.
>
> Sanjay recomputes his 2006 tax as if the taxable grant was only $11,000. His recomputed tax liability is now $256. Sanjay claims a tax credit on his 2007 return for $402 (the difference between the $658 original tax and the $256 recomputed tax).

---

56. Form 1040A Instructions

An amended return may be filed when the reduction increases the amount of the tuition and fees deduction or the education tax credit claimed in the prior year.

Example 33. In 2006, Katie's tuition and fees were $5,000. Katie received a $4,000 scholarship, which she treated as nontaxable. Katie claimed a tuition and fees deduction on the remaining $1,000.

In 2007, Katie's $4,000 scholarship for 2006 was retroactively reduced to only $2,000. Katie may amend her 2006 return, using $3,000 to compute her tuition and fees deduction.

Box 7 — Academic Period Beginning in January through March. This box is checked if the amounts in box 1 or 2 include amounts for an academic period beginning in January, February, or March 2009. The Hope and lifetime learning tax credits and the tuition and fees deduction are allowed for expenses paid for academic periods beginning during the taxable year or during the first three months of the following year.

Box 8 — At Least Half-Time Student. This box is checked if the student is at least half time for at least one academic period during the year. In order to claim the Hope credit, this unique requirement must be met.

Box 9 — Graduate Student. This box is checked if the student is considered a graduate student.

Box 10 — Insurance Contract Reimbursements or Refunds. This box shows the amount of refunds or reimbursements of qualified tuition and fees made by an insurer.

If a taxpayer receives a Form 1098-T that is believed to contain errors, the taxpayer must contact the educational institution and request a corrected Form 1098-T. The taxpayer should receive a new Form 1098-T with an "X" entered in the "CORRECTED" box at the top of the form from the educational institution.

U.S. SAVINGS BONDS

INTEREST-INCOME EXCLUSION

Interest income from Series EE and Series I bonds issued after 1989 is excludable from gross income to the extent the bond proceeds are used to pay for QHEE or are contributed to a QTP or Coverdell ESA for the benefit of the student.[57] This exclusion is claimed on Form 8815, *Exclusion of Interest from Series EE and I U.S. Savings Bonds Issued after 1989.*

Qualified Expenses

As with other education tax incentives, QHEE includes the following:

- Tuition and fees paid on behalf of the taxpayer, the taxpayer's spouse, or the taxpayer's dependent for whom an exemption is claimed[58]
- Contributions to a Coverdell education savings account (ESA) on behalf of a designated beneficiary who is the taxpayer, the taxpayer's spouse, or the taxpayer's dependent (The earnings portion of the U.S. savings bonds is not included in the taxpayer's basis in the Coverdell ESA.)[59]
- Contributions to a §529 plan on behalf of a designated beneficiary who is the taxpayer, the taxpayer's spouse, or the taxpayer's dependent (The earnings portion of the U.S. savings bonds is not included in the taxpayer's basis in the §529 plan.)[60]

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57. IRC §135(a); Form 8815 Instructions
58. IRC §135(c)(2)(A)
59. IRC §135(c)(2)(C)
60. Ibid

As with other education tax incentives, QHEE expenses must be reduced by all of the following tax-free benefits to arrive at AQEE:

- Tax-free scholarships[61]
- Expenses used to compute tax-free withdrawals from Coverdell ESAs[62]
- Expenses used to compute tax-free withdrawals from §529 plans[63]
- Expenses used to compute the Hope or lifetime learning tax credit[64]
- Any other nontaxable payments received for educational expenses such as:
  - Veterans' educational assistance benefits,
  - Qualified tuition reductions, or
  - Employer-provided educational assistance.[65]

Income Limitations

The interest exclusion is phased out for higher-income taxpayers based on MAGI.[66] MAGI is AGI with the following additions:

- Foreign earned income and housing exclusions and deductions[67]
- Exclusion of income from American Samoa or Puerto Rico[68]
- Exclusion for adoption benefits received under an adoption assistance program[69]
- Deduction for student-loan interest[70]
- Deduction for tuition and fees[71]

2008 U.S. Savings Bond Interest Exclusion Income Limitations

Filing Status	MAGI Phaseout Range
MFJ, QW	$100,650–130,650
Single, HOH	67,100– 82,100
MFS	N/A

61. IRC §135(d)(1)
62. IRC §135(d)(2)(B)
63. Ibid
64. IRC §135(d)(2)(A)
65. IRC §135(d)(1)
66. IRC §135(b)(2)
67. IRC §135(c)(4)
68. Ibid
69. Ibid
70. Ibid
71. Ibid

Example 34. Marshall and Gwenella have a daughter, Sophia. In 1994, when she was 3 years old, Marshall and Gwenella purchased Series EE and I savings bonds to save for her education. In 2008, Marshall anticipates his MAGI will be $95,000, which is in the range where the interest income will be excluded if it is spent on qualifying educational expenses.

Gwenella decides she will return to work next year. She anticipates that she will earn $40,000. This will put Marshall and Gwenella's MAGI at $135,000. Therefore, all the interest from the Series EE and I bonds will be included in income even if it is spent on qualifying educational expenses.

Marshall and Gwenella decide to immediately cash in all their Series EE and I savings bonds and deposit the proceeds into a §529 plan account for their daughter. This contribution includes $50,000 of principal and $10,000 of interest. Because their income is still in the appropriate range, Marshall and Gwenella can consider the §529 plan contributions as allowable educational expenses for the interest exclusion.

If they waited to cash the savings bonds until the year Gwenella returned to work, they would not qualify for the interest exclusion.

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. 1545-0074
2008
Attachment Sequence No. 57

Name(s) shown on return	Your social security number
Marshall and Gwenella	111 22 3333

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
Sophia	University of Hawaii Kona Avenue, Honolulu, Hawaii

If you need more space, attach a statement.

2	Enter the total qualified higher education expenses you paid in 2008 for the person(s) listed in column (a) of line 1. See the instructions to find out which expenses qualify	2	60,000
3	Enter the total of any nontaxable educational benefits (such as nontaxable scholarship or fellowship grants) received for 2008 for the person(s) listed in column (a) of line 1 (see instructions)	3	0
4	Subtract line 3 from line 2. If zero or less, **stop.** You **cannot** take the exclusion	4	60,000
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 2008**	5	60,000
6	Enter the interest included on line 5 (see instructions)	6	10,000
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	× 1 . 000
8	Multiply line 6 by line 7	8	10,000
9	Enter your modified adjusted gross income (see instructions) — 9: 95,000 **Note:** *If line 9 is $82,100 or more if single or head of household, or $130,650 or more if married filing jointly or qualifying widow(er),* ***stop.*** *You* ***cannot*** *take the exclusion.*		
10	Enter: $67,100 if single or head of household; $100,650 if married filing jointly or qualifying widow(er) — 10: 100,650		
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	0
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	10,000

EDUCATION LOANS

OVERVIEW

Graduating from college without debt is desirable but may not be possible for many families. It is common for part or all of a student's educational costs to be funded with loans. Fortunately, there are numerous college loan options. Many of these loans have generous terms, low interest rates, and a possibility of loan forgiveness. Consequently, they can be a valuable part of a family's college funding strategy.

Most financial-aid packages offered by colleges and universities include loans as part of the package. According to the College Board, loans are now the largest form of student aid, making up 51% of the total financial aid awarded each year.

The Taxpayer Relief Act of 1997 added IRC §221 to the Code. This section governs interest deductions on education loans. Qualified education loans are defined as any indebtedness incurred by the taxpayer solely to pay qualified higher-education expenses. This does not include any loan provided by a related person, or a loan provided under a qualified employer plan.[72]

With the exception of interest paid on qualifying educational loans and certain home equity loans, interest paid on loans used for education is considered personal interest and is not deductible. However, when a taxpayer's MAGI is less than $70,000 ($145,000 for married filing jointly), a special deduction is allowed for interest paid on an education loan used for higher education.

In 2008, the deduction is the smaller of the interest amount actually paid or $2,500. The deduction is phased out based on the taxpayer's MAGI, which is discussed later in this section. This deduction is taken as an adjustment to income. Consequently, even taxpayers who do not itemize can benefit from this deduction.

Qualified Education Loan

A qualified education loan is a loan taken out solely to pay for QHEE. It does not have to be a federal education loan to be considered qualified.[73] A **qualified education loan** must be:

- For the taxpayer, the taxpayer's spouse, or the taxpayer's dependent;
- For QHEE paid or incurred within a reasonable period of time before or after obtaining the loan; and
- For education provided during an academic period for a student enrolled at least half time.[74]

The qualified education loan cannot be from a related person or a qualified employer plan.

In addition to simple interest on the loan, **other items can be considered education loan interest:**

- Loan origination fee
- Capitalized interest
- Interest on revolving lines of credit
- Interest on refinanced student loans
- Voluntary interest payments

---

72. IRC §221(d)(1)

73. Treas. Reg. §1.221-1(e)(3)(iv)

74. IRS Pub. 970, *Tax Benefits for Education* (2007)

Example 35. Jason has a qualified education loan. He is a full-time student and is not required to make payments until after he graduates. Jason decides to make voluntary interest payments on the loan. He can deduct this as education-loan interest, provided he meets the other requirements.

Interest on education loans can be deducted on annual tax returns until the loan is paid in full.

Education Loan Interest Deduction

Generally, the **education loan interest deduction** can be claimed if all the following requirements are met:

- The taxpayer's filing status is anything except married filing separately.
- No one else claims an exemption for the taxpayer.
- The taxpayer is legally obligated to pay interest on the qualified education loan.
- The taxpayer paid the interest on the qualified education loan.

There is **no double benefit** for the interest. The deduction cannot be claimed if the interest on the qualified education loan is an allowable deduction under any other provision of the Code (e.g., home mortgage interest).

Interest paid by a third party is considered paid by the taxpayer who is legally obligated to make the payments. The taxpayer is treated as if he received the payment from the third party and, in turn, paid the interest.[75] The third-party payment is treated as a gift made by the third party to the taxpayer.

Income Limitations

The **education loan interest deduction** is phased out ratably for taxpayers based on MAGI. For purposes of the student loan interest deduction, MAGI is AGI with the following additions:

- Foreign earned income and housing exclusions and deductions
- Exclusion of income from American Samoa or Puerto Rico
- The domestic production activities deduction
- The tuition and fees deduction[76]

2008 Phaseout of Deductions for Education Loan Interest

Filing Status	MAGI Phaseout Range
MFJ	$115,000–145,000
Single, HOH, QW	55,000– 70,000
MFS	N/A

The deduction is calculated as follows:

Step 1. Determine the lesser of $2,500 or the amount of qualifying interest paid.

Step 2. Multiply the amount in Step 1 by the following fraction: (MAGI – $55,000 or $115,000 for MFJ) ÷ $15,000 or $30,000 for MFJ.

Step 3. Subtract this amount from the amount determined in Step 1.[77]

75. Treas. Reg. §1.221-1(b)(4)(i)

76. IRC §221(b)(2)(C)

77. IRC §221(b)(2)(B)

Example 36. Jeannie files as married filing jointly. She paid $800 interest on a qualified student loan. The MAGI for her and her husband is $140,000. Jeannie's deduction is calculated as follows:

$800 × (($140,000 – $115,000) ÷ $30,000) = $667

$800 – $667 = $133 tax deduction for education loan interest

Example 37. Use the same facts as **Example 36,** except Jeannie paid $2,750 of interest.

Jeannie's deduction is calculated as follows:

$2,500 × (($140,000 – $115,000) ÷ $30,000) = $2,083

$2,500 – $2,083 = $417 tax deduction for education loan interest

Form 1098-E

Form 1098-E, *Student Loan Interest Statement*, is the information form used to report the amount of interest the taxpayer paid on the loan for the calendar year.

☐ CORRECTED (if checked)

RECIPIENT'S/LENDER'S name, address, and telephone number			OMB No. 1545-1576 2008 Form 1098-E	Student Loan Interest Statement
RECIPIENT'S federal identification no.	BORROWER'S social security number	1 Student loan interest received by lender $		Copy B For Borrower This is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if the IRS determines that an underpayment of tax results because you overstated a deduction for student loan interest.
BORROWER'S name Street address (including apt. no.) City, state, and ZIP code				
Account number (see instructions)		2 Box 1 includes loan origination fees and/or capitalized interest (if checked) . . . . . . ☐		

Form **1098-E** (keep for your records) Department of the Treasury - Internal Revenue Service

> **Note.** The 2009 draft Form 1098-E contains different language in box 2. The 2009 version includes the following in box 2: "Check if box 1 does **not** include loan origination fees and/or capitalized interest, and the loan was made before September 1, 2004."

HOME-EQUITY INDEBTEDNESS

If a home-equity loan is used exclusively for college expenses, the loan can be treated as a qualified education loan, and the interest paid can be deducted under those provisions. In order to receive the proper tax reporting from the lender, the borrower may need to certify that the home-equity-loan proceeds will be used exclusively for college expenses. Home-equity indebtedness used for education is not deductible for alternative minimum tax (AMT) purposes.

FEDERAL STUDENT-LOAN PROGRAMS

The U.S. Department of Education administers federal student-loan programs. These loan programs are a source of low-interest loans for both students and parents. Following is a quick overview of the available federal loan programs.

Federal Perkins Loans

Federal Perkins loans are awarded to students who show "exceptional need" as determined by the school. Perkins loans are a source of low-interest loans for undergraduate, graduate, and professional degree students. They are usually the best student loan available. Perkins loans offer a low fixed-interest rate, no fees, and the best deferment and cancellation provisions.

The current interest rate is 5% for Perkins loans. Repayment expectations and interest accrual do not begin until nine months after the student ceases to be enrolled at least half time. There are no loan origination fees.

Payments on a Perkins loan **may be deferred** for the following reasons:

- The student returned to school on a least a half-time basis.
- The student is suffering economic hardship.
- The student is unable to find full-time employment.
- The student is performing services qualifying him for loan cancellation.

During deferment, the student is allowed to temporarily postpone payment and interest ceases to accrue.

Part or all of Perkins loans **may be cancelled** for the following reasons:

- Student's total and permanent disability or death
- Service as a full-time teacher in a designated elementary or secondary school serving students from low-income families
- Service as a full-time special education teacher (teaching children with disabilities in a public or other nonprofit elementary or secondary school)
- Service as a full-time qualified professional provider of early intervention services for the disabled
- Service as a full-time teacher of math, science, foreign languages, bilingual education, or other fields designated as teacher-shortage areas
- Service as a full-time employee of a public or nonprofit child or family services agency providing services to high-risk children and their families from low-income communities
- Service as a full-time nurse or medical technician
- Service as a full-time law enforcement or corrections officer
- Service as a full-time staff member in the education component of a Head Start Program
- Service as a Peace Corps Domestic Volunteer Service Act volunteer
- Service in the U.S. Armed Forces in areas of hostilities or imminent danger
- Student's bankruptcy, but only if the bankruptcy court rules that repayment would cause undue hardship
- Closure of the college before the student can complete the program of study

Note. A list of the current teacher shortage areas is available on the Internet at: **tinyurl.com/5uxjr9.**

A percentage of the Perkins loan can be cancelled for each completed year of qualifying service or employment. Generally, when a loan is cancelled the borrower has cancellation of indebtedness income. However, certain student loans, like Perkins loans, qualify for tax-free treatment upon cancellation.

If a student loan was made by a qualified lender and the student loan is forgiven contingent on the student's working for a certain period of time in certain professions for any of a broad class of employers, then the student does not have any cancellation of indebtedness income to recognize.[78]

Example 38. After Marcella graduated as a math teacher, she taught in a school system located in a designated teacher-shortage area. A portion of her Perkins loan was forgiven. Marcella does not have any cancellation of indebtedness income to recognize.

Example 39. After Wade graduated as a math teacher, he taught in a high-income school system (not a designated teacher-shortage area). The high-income school system promised to pay $10,000 of his Perkins loans. Wade has $10,000 of additional income to recognize.

Stafford Loans

Stafford loans are the largest source of low-interest loans administered by the Department of Education. Depending upon the school, Stafford loans are available under one of the following programs:

- Federal Family Education Loan Program (FFEL Program) provides funds through a lender such as a bank or credit union.
- William D. Ford Federal Direct Loan Program (Direct Loan Program) provides funds directly from the federal government. The school is responsible for determining the student's eligibility and disbursing the loan proceeds to the student.

Federal Stafford loans may be either subsidized or unsubsidized. The federal government pays the interest on a **subsidized loan** while the student is enrolled in school at least half time, during the grace period before the loan enters repayment, and during a deferment period. The student must demonstrate financial need to be eligible for a subsidized loan.

The student must pay all interest on an **unsubsidized loan.** While the student is enrolled or in a deferment status, she can either pay the interest as it accrues or have the interest capitalized. Unsubsidized loans are intended to provide assistance to students who may not demonstrate need under the federal methodology formula for financial aid.

Example 40. Janet, who is still in college, has a $10,000 subsidized Stafford loan and a $10,000 unsubsidized Stafford loan. The $680 of interest on her subsidized loan is being paid by the federal government. Janet must either pay the $680 interest on her unsubsidized loan or capitalize it and add $680 to her loan balance.

The interest rate for federal Stafford loans disbursed on or after July 1, 2006, is fixed. The current rate is 6.8%. In addition to interest, federal Stafford loan borrowers are charged loan fees of up to 4% of the principal amount of the loan. These fees are deducted from each loan disbursement.

Repayment on Stafford loans begins six months after the student graduates or ceases to be enrolled at least half time.

Deferment of a Stafford loan depends upon whether the loan is subsidized or unsubsidized. For a subsidized loan, the federal government pays the interest during loan deferment. For an unsubsidized loan, the student must continue to pay all interest accruing on the loan. Lenders have the option of capitalizing interest during a deferment period.

78. IRC §108(f)

Payments on a Stafford loan **may be deferred** for the following reasons:

- The student returned to school on a least a half-time basis.
- The student is suffering economic hardship.
- The student is unable to find full-time employment.

Deferment must be formally requested. Students must continue to make payments until they are notified that the deferment is approved. Deferment is not available on loans in default.

Part or all of Stafford loans **may be cancelled** for the following reasons:

- Student's total and permanent disability or death
- Service as a full-time teacher for five consecutive years in a designated elementary or secondary school serving students from low-income families
- Student's bankruptcy, but only if the bankruptcy court rules that repayment would cause undue hardship
- Closure of the college before the student can complete the program of study

PLUS Loans for Parents

PLUS loans are a source of long-term loans for the parents of dependent undergraduate students. Depending upon the school, PLUS loans are available under either the FFEL Program or the Direct Loan Program. Under the PLUS loan program, parents can borrow up to the full cost of attendance at a college minus any other financial aid for which the family is eligible.

The interest rate for PLUS loans disbursed on or after July 1, 2006, is fixed. The current rate is 8.5%. In addition to interest, PLUS loan borrowers are charged loan fees of up to 4% of the principal amount of the loan. These fees are deducted from each loan disbursement. Interest rates on PLUS loans disbursed between July 1, 1998, and July 1, 2006, are variable. New rates for these loans are computed annually on July 1.

Repayment begins when the loan is disbursed. The first payment of interest and principal is due 60 days after the loan's disbursement. Parents have the option to pay interest only during the school years.

Deferment provisions for PLUS loans relate to the parent borrower's circumstances. Deferment of a PLUS loan is for principal only; the borrower must continue to pay all interest accruing on the loan. Lenders have the option of capitalizing interest during a deferment period. PLUS loans may be deferred for the following reasons:

- The parent borrower is seeking and unable to find employment.
- The parent borrower is experiencing economic hardship. Economic hardship exists when the parent is working full-time and income is less than the poverty level for a family of two, he is earning less than minimum wage, or his monthly payments on federal education loans are equal to or greater than 20% of gross monthly income.

Part or all of PLUS loans may be cancelled for the following reasons:

- Parent's total and permanent disability or death
- Student's death
- Parents' bankruptcy, but only if the bankruptcy court rules that repayment would cause undue hardship
- Closure of the college before the student can complete the program of study