Chapter 2: Education

Corrections were made to this material through January of 2012. No subsequent modifications were made.

EDUCATION CREDITS

Education credits offset the cost of higher learning for taxpayers, their spouses, and dependents. The American Recovery and Reinvestment Act of 2009 (ARRA) significantly changed education credits starting in 2009, most notably by introducing the American opportunity credit (AOC).

AMERICAN OPPORTUNITY CREDIT

The ARRA significantly inflated the scope and benefits of the Hope credit, which was rebranded as the AOC for 2009–2012. The AOC differs from the Hope credit in the following ways.

- The maximum amount of the AOC per eligible student is $2,500 (100% of the first $2,000 of qualifying expenses and 25% of the next $2,000). Prior to the introduction of the AOC, the maximum Hope credit was $1,800.
- The AOC is available for the first **four** years of postsecondary education in degree or certificate programs. Previously, the Hope credit was only available for the first **two** years of postsecondary education.
- Course materials are included in the definition of qualifying expenses for the AOC.
- The phaseout range for the AOC is $80,000 to $90,000 for single taxpayers and $160,000 to $180,000 for married couples filing jointly. For 2008, the ranges for the Hope credit were $48,000 to $58,000 (single taxpayers) and $96,000 to $116,000 (MFJ).
- The AOC can be claimed against alternative minimum tax (AMT) liability.
- Forty percent of the AOC is **refundable,** although none of this credit is refundable to those taxpayers subject to the kiddie tax. The Hope credit was nonrefundable.

Eligible Students

Eligible students for purposes of the AOC must meet all the following requirements.

- The student did not have expenses that were used to figure the AOC in any four earlier tax years.
- The student has not completed the first four years of postsecondary education. **Years** in this context refers to the class standing of the student with the educational institution. The student's class standing at the beginning of the calendar 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.

> **Planning Tip.** For 2011 returns, practitioners are advised to review previous years' returns to ensure the AOC/Hope credits were not claimed for the maximum of four years.

Eligible Educational Institution

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

Qualified Expenses

Qualified higher education expenses (QHEE) for the AOC are tuition and related expenses required for enrollment or attendance at an eligible educational institution.

QHEE must be paid **on behalf of** the taxpayer, the taxpayer's spouse, or the taxpayer's dependent for whom an exemption is claimed.[1] If the taxpayer claims an exemption for a dependent who is an eligible student, then the taxpayer can claim the AOC but the dependent cannot. Conversely, if a taxpayer does not claim an exemption for a dependent who is an eligible student (even if entitled to the exemption), then the dependent can claim the AOC but the taxpayer cannot.[2]

> **Note.** Qualified expenses paid by the dependent or any other party are treated as paid by the taxpayer claiming the student as a dependent.[3]

Student activity fees are included as QHEE only if they must be paid to the educational institution **as a condition of enrollment or attendance.** Expenses for books, supplies, and equipment needed for a course of study are considered QHEE even if they are not purchased from the educational institution.

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]

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1. IRC §25A(f)(1).
2. IRS Pub. 970, *Tax Benefits for Education*.
3. IRC §25A(g)(3).
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]
- Pell grants
- Expenses used to compute tax-free withdrawals from Coverdell Education Savings Accounts (ESAs)[6]
- Expenses used to compute tax-free withdrawals from a §529 plan[7]
- Expenses used to compute the interest exclusion from U.S. savings bonds[8]
- Any other nontaxable payments received for educational expenses such as:
    - Veterans' educational assistance benefits,[9]
    - Qualified tuition reductions, and
    - 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, 2010, Elizabeth receives her tuition bill for the spring semester, which begins January 15, 2011. Elizabeth pays the tuition bill in December. Therefore, she can claim the AOC on her **2010** return. If Elizabeth waits until January to pay the tuition bill, she cannot claim the credit until she files her **2011** return.

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]

Income Limitations

The AOC is phased out for higher-income taxpayers based on modified adjusted gross income (MAGI). MAGI is adjusted gross income (AGI) with the following additions.[13]

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

American Opportunity Credit Income Limitations[14]

Filing Status	2011 Phaseout Range
Married filing jointly (MFJ)	$160,000–$180,000
Single, head of household (HoH), qualifying widow(er) (QW)	80,000–90,000
Married filing separately (MFS)	N/A

5. IRC §25A(g)(2)(A).
6. IRC §530(d)(2)(C).
7. Ibid.
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).
13. IRC §25A(d)(3).
14. Rev. Proc. 2011-12, 2011-2 IRB 299.

Calculating the Credits

Form 8863, *Education Credits (American Opportunity and Lifetime Learning Credits),* is used to compute both the AOC and the lifetime learning credits. The taxpayer's **tentative** AOC is calculated in Part I. The refundable portion of the AOC is calculated in Part III and the nonrefundable portion in Part IV.

> **Note.** IRS draft forms for 2011 were not available at the time of publication. The 2011 Form 8863 may have different line numbers. Consequently, the following example uses 2010 calculations even though 2011 income limitations are available.

Example 2. Bruce Buford is a single father with AGI of $15,000 in 2010. His daughter, Bella, attends Iowa State University. Bella's 2010 qualified educational expenses are $10,000 which is paid with a student loan. Bruce's tax liability is zero. Bruce is eligible to claim a refundable AOC of $1,000 ($2,500 × 40%).

Following is Bruce's 2010 Form 8863.

Form **8863**

Department of the Treasury
Internal Revenue Service (99)

Education Credits (American Opportunity and Lifetime Learning Credits)

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

OMB No. 1545-0074
2010
Attachment Sequence No. 50

Name(s) shown on return: **Bruce Buford**
Your social security number: **555-55-5555**

CAUTION: ***You cannot*** *take both an education credit and the tuition and fees deduction (see Form 8917) for the* ***same student*** *for the same year.*

Part I American Opportunity Credit
Caution: *You* ***cannot*** *take the American opportunity credit for more than* ***4*** *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 $4,000 for each student.	**(d)** Subtract $2,000 from the amount in column (c). If zero or less, enter -0-.	**(e)** Multiply the amount in column (d) by 25% (.25)	**(f)** If column (d) is zero, enter the amount from column (c). Otherwise, add $2,000 to the amount in column (e).
	Bella Buford	123-45-6789	4,000	2,000	500	2,500

2	**Tentative American opportunity credit.** Add the amounts on line 1, column (f). If you are taking the lifetime learning credit for a different student, go to Part II; otherwise, go to Part III . . . . ▶	2	2,500

Part II Lifetime Learning Credit
Caution: *You* ***cannot*** *take the American opportunity credit and the lifetime learning credit for the* ***same student*** *in the same year.*

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). If you have an entry on line 2, go to Part III; otherwise go to Part IV	6	

For Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 25379M Form **8863** (2010)

For Example 2

Form 8863 (2010) Page 2

Part III Refundable American Opportunity Credit

7	Enter the amount from line 2			7	2,500
8	Enter: $180,000 if married filing jointly; $90,000 if single, head of household, or qualifying widow(er)	8	90,000		
9	Enter the amount from Form 1040, line 38,* or Form 1040A, line 22	9	15,000		
10	Subtract line 9 from line 8. If zero or less, **stop**; you cannot take any education credit	10	75,000		
11	Enter: $20,000 if married filing jointly; $10,000 if single, head of household, or qualifying widow(er)	11	10,000		
12	If line 10 is: • Equal to or more than line 11, enter 1.000 on line 12 • Less than line 11, divide line 10 by line 11. Enter the result as a decimal (rounded to at least three places)			12	1.000
13	Multiply line 7 by line 12. **Caution:** If you were under age 24 at the end of the year **and** meet the conditions on page 4 of the instructions, you **cannot** take the refundable American opportunity credit. Skip line 14, enter the amount from line 13 on line 15, and check this box ▶ ☐			13	2,500
14	**Refundable American opportunity credit.** Multiply line 13 by 40% (.40). Enter the amount here and on Form 1040, line 66, or Form 1040A, line 43. Then go to line 15 below			14	1,000

Part IV Nonrefundable Education Credits

15	Subtract line 14 from line 13			15	1,500
16	Enter the amount from line 6, if any. If you have no entry on line 6, skip lines 17 through 22, and enter the amount from line 15 on line 6 of the Credit Limit Worksheet (see instructions)			16	
17	Enter: $120,000 if married filing jointly; $60,000 if single, head of household, or qualifying widow(er)	17			
18	Enter the amount from Form 1040, line 38,* or Form 1040A, line 22	18			
19	Subtract line 18 from line 17. If zero or less, skip lines 20 and 21, and enter zero on line 22	19			
20	Enter: $20,000 if married filing jointly; $10,000 if single, head of household, or qualifying widow(er)	20			
21	If line 19 is: • Equal to or more than line 20, enter 1.000 on line 21 and go to line 22 • Less than line 20, divide line 19 by line 20. Enter the result as a decimal (rounded to at least three places)			21	.
22	Multiply line 16 by line 21. Enter here and on line 1 of the Credit Limit Worksheet (see instructions) ▶			22	
23	**Nonrefundable education credits.** Enter the amount from line 11 of the Credit Limit Worksheet (see instructions) here and on Form 1040, line 49, or Form 1040A, line 31			23	0

*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.

Form **8863** (2010)

LIFETIME LEARNING CREDIT

The **lifetime learning** credit is a **nonrefundable credit** 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.

Eligible Students

A student is considered eligible if the student is enrolled in one or more courses at an eligible educational institution.

> **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.

The following taxpayers **cannot claim** the lifetime learning credit.

- MFS taxpayers
- Taxpayers listed as a dependent on another person's tax return
- Taxpayers who are nonresident aliens and who do not elect to be treated as resident aliens

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

Eligible Educational Institution

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

Qualified Expenses

QHEE for the lifetime learning credit are generally the same as those allowed for the AOC. However, allowable courses for the lifetime learning credit include those taken to **acquire or improve job skills** in addition to those that are a part of a postsecondary degree program.

Income Limitations

The lifetime learning credit is phased out for higher-income taxpayers based on MAGI, as shown in the following table:

Lifetime Learning Credit Income Limitations [15]

Filing Status	2011 Phaseout Range
MFJ	$102,000–$122,000
Single, HoH, QW	51,000–61,000
MFS	N/A

Calculating the Credits

Form 8863, *Education Credits (American Opportunity and Lifetime Learning Credits),* is used to compute both the AOC and the lifetime learning credit. Based on the taxpayer's AQEE, Part II of Form 8863 is used to calculate the **tentative** lifetime learning credit. The taxpayer's **allowable education credit** is calculated in Part IV, based on applicable income limitations.

> **Note.** IRS draft forms for 2011 were not available at the time of publication. The 2011 Form 8863 will have different phaseout amounts and may have different line numbers. Consequently, the following example uses 2010 calculations even though 2011 income limitations are available.

[15] Rev. Proc. 2011-12, 2011-2 IRB 299.

Example 3. Craig and Sara Bookman file a joint return and have a 2010 MAGI of $110,000. They paid $10,000 of qualified education expenses during the year for their daughter, Amie. Amie is enrolled in graduate school.

Because Craig and Sara's MAGI is within the range in which the credit must be reduced, they do not qualify for the maximum $2,000 lifetime learning credit.

They file the following Form 8863 to calculate and claim the lifetime learning credit. Craig and Sara are entitled to a $1,000 lifetime learning credit (line 23).

Form **8863**

Department of the Treasury
Internal Revenue Service (99)

Education Credits (American Opportunity and Lifetime Learning Credits)

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

OMB No. 1545-0074
2010
Attachment Sequence No. **50**

Name(s) shown on return	Your social security number
Craig & Sara Bookman	999-88-7777

CAUTION: ***You cannot*** *take both an education credit and the tuition and fees deduction (see Form 8917) for the* ***same student*** *for the same year.*

Part I American Opportunity Credit

Caution: *You* ***cannot*** *take the American opportunity credit for more than* ***4*** *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 $4,000 for each student.	(d) Subtract $2,000 from the amount in column (c). If zero or less, enter -0-.	(e) Multiply the amount in column (d) by 25% (.25)	(f) If column (d) is zero, enter the amount from column (c). Otherwise, add $2,000 to the amount in column (e).

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

Part II Lifetime Learning Credit

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

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)
	Amie	Bookman	555-44-3333	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). If you have an entry on line 2, go to Part III; otherwise go to Part IV	6	2,000

For Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 25379M Form **8863** (2010)

For Example 3

Form 8863 (2010) Page **2**

Part III Refundable American Opportunity Credit

7	Enter the amount from line 2			7	
8	Enter: $180,000 if married filing jointly; $90,000 if single, head of household, or qualifying widow(er)	8			
9	Enter the amount from Form 1040, line 38,* or Form 1040A, line 22	9			
10	Subtract line 9 from line 8. If zero or less, **stop**; you cannot take any education credit	10			
11	Enter: $20,000 if married filing jointly; $10,000 if single, head of household, or qualifying widow(er)	11			
12	If line 10 is: • Equal to or more than line 11, enter 1.000 on line 12 • 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. **Caution:** If you were under age 24 at the end of the year **and** meet the conditions on page 4 of the instructions, you **cannot** take the refundable American opportunity credit. Skip line 14, enter the amount from line 13 on line 15, and check this box ▶ ☐			13	
14	**Refundable American opportunity credit.** Multiply line 13 by 40% (.40). Enter the amount here and on Form 1040, line 66, or Form 1040A, line 43. Then go to line 15 below			14	

Part IV Nonrefundable Education Credits

15	Subtract line 14 from line 13			15	
16	Enter the amount from line 6, if any. If you have no entry on line 6, skip lines 17 through 22, and enter the amount from line 15 on line 6 of the Credit Limit Worksheet (see instructions)			16	2,000
17	Enter: $120,000 if married filing jointly; $60,000 if single, head of household, or qualifying widow(er)	17	120,000		
18	Enter the amount from Form 1040, line 38,* or Form 1040A, line 22	18	110,000		
19	Subtract line 18 from line 17. If zero or less, skip lines 20 and 21, and enter zero on line 22	19	10,000		
20	Enter: $20,000 if married filing jointly; $10,000 if single, head of household, or qualifying widow(er)	20	20,000		
21	If line 19 is: • Equal to or more than line 20, enter 1.000 on line 21 and go to line 22 • Less than line 20, divide line 19 by line 20. Enter the result as a decimal (rounded to at least three places)			21	.500
22	Multiply line 16 by line 21. Enter here and on line 1 of the Credit Limit Worksheet (see instructions) ▶			22	1,000
23	**Nonrefundable education credits.** Enter the amount from line 11 of the Credit Limit Worksheet (see instructions) here and on Form 1040, line 49, or Form 1040A, line 31			23	1,000

*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.

Form **8863** (2010)

TUITION AND FEES DEDUCTION

The tuition and fees deduction can reduce AGI by up to $4,000. This tax incentive provides an above-the-line deduction for certain QHEE. It is claimed by filing Form 8917, *Tuition and Fees Deduction*. The deduction is **not allowed** if the taxpayer claims either the AOC or lifetime learning credit for the same student.

Note. The tuition and fees deduction was set to expire at the end of 2009 under the sunset provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA). However, in December 2010, Congress passed the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, which extended the tuition and fees deduction through the end of 2011.

INCOME LIMITATIONS

The amount of the tuition and fees deduction varies based upon the MAGI of the taxpayer, as shown in the following table:

2011 Tuition and Fees Deduction[16]

Filing Status	MAGI Phaseout Range	Maximum Deduction
Single, HoH, QW	$ 0– 65,000	$4,000
MFJ	0–130,000	4,000
Single, HoH, QW	65,001– 80,000	2,000
MFJ	130,001–160,000	2,000

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.[17] Fees and expenses for books, supplies, and equipment qualify 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 AOC and lifetime learning credits, QHEE must be reduced by these tax-free benefits to arrive at AQEE.

- Tax-free scholarships and fellowships[18]
- Pell grants[19]
- Expenses used to compute tax-free withdrawals from Coverdell ESAs[20]
- The excludable **income** portion of a distribution from a §529 plan[21]
- Expenses used to compute tax-free interest from U.S. savings bonds[22]
- Any other nontaxable payments received for educational expenses such as:
  - Veterans' educational assistance benefits,
  - Qualified tuition reductions, and
  - Employer-provided educational assistance.

16. Joint Committee on Taxation, Technical Explanation of the Revenue Provisions Contained in the "Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010." Scheduled for Consideration by the United States Senate (JCX-55-10), Dec. 10, 2010.

17. IRC §222(d)(1).

18. IRS Pub. 970, *Tax Benefits for Education*.

19. Ibid.

20. IRC §222(c)(2)(B).

21. Ibid.

22. Ibid.

Example 4. Rhonda 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.

Rhonda 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 5. Use the same facts as **Example 4,** except the distribution was from a §529 plan. The §529 plan distribution includes $800 of contributions and $200 of earnings.

Rhonda's AQEE for purposes of the tuition and fees deduction is $800 because 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 AOC requirements, the eligible student does not have to be enrolled in school at least half time.

Eligible Educational Institution

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

Other Requirements

The tuition and fees deduction is **not allowed** if any of the following apply.

- The taxpayer is **claimed as a dependent** on someone else's return.
- The taxpayer's filing status is **married filing separately.**[23]
- The taxpayer or spouse is a **nonresident alien and did not elect to be treated as a resident alien** for tax purposes.[24]
- The tuition and fees are being deducted under any other provision of the tax law.[25]
- The taxpayer is **claiming an AOC or lifetime learning credit for the same student.**[26]

Eligibility for Deduction

In order to claim the tuition and fees deduction, the taxpayer must:

- Have paid the eligible expenses, and
- Claim an exemption for the eligible student as a dependent.

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

23. IRC §222(d)(4).
24. IRC §222(d)(5).
25. IRC §222(c)(1).
26. IRC §222(c)(2)(A).

Example 6. Mike's qualifying tuition and fees at Exel University were $5,000 for the year. Mike was enrolled in two classes for the spring semester and two classes for the fall semester, which is less than half-time enrollment at Exel. Mike paid $2,000 of his tuition and the remaining $3,000 was paid by his mother, Bonnie. Bonnie's AGI before the tuition and fees deduction is $62,500. When Bonnie files her return claiming Mike as a dependent, she can only use the $3,000 she paid when calculating her tuition and fees deduction. Mike is not eligible for the tuition and fees deduction for the $2,000 that he paid because he was claimed as a dependent by Bonnie.

Note. Bonnie is not eligible to claim the AOC because Mike is not enrolled at least half time. Mike is also not eligible for the lifetime learning credit because he is claimed as a dependent by Bonnie; however, Bonnie is not eligible for the lifetime learning credit because her AGI is too high.

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** for the eligible student, then no one is allowed to claim the tuition and fees deduction.

Example 7. Use the same facts as **Example 6,** except all of 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 should consider providing a gift of the amount of the tuition and fees to Bonnie, who could then pay 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.

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 or another person are treated as a gift to the student. The student can then use those educational expenses to calculate the tuition and fees deduction.

Example 8. Use the same facts as **Example 7,** except Mike is not eligible to be claimed as a dependent on Bonnie's return. His MAGI for 2010 is $26,000. Mike's income tax liability before credits is $2,083. Mike can use his grandfather's payment of the $5,000 of tuition and fees to calculate his 2010 tuition and fees deduction of $4,000. His Form 8917 is shown here.

Note. Bonnie and Mike should compare all applicable education credits and deductions to maximize the education benefit.

For Example 8

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
2010
Attachment Sequence No. 60

Name(s) shown on return	Your social security number
Mike Jones	111-55-1111

CAUTION: *You **cannot** take both an education credit from Form 8863 and the tuition and fees deduction from this form for the **same student** for the same tax 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, figure any write-in adjustments to be entered on the dotted line next to Form 1040, line 36. See the 2010 Form 1040 instructions for 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	Jones	111-55-1111	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
	*If you are filing Form 2555, 2555-EZ, or 4563, or you are excluding income from Puerto Rico, see *Effect of the Amount of Your Income on the Amount of Your Deduction* in Pub. 970, chapter 6, to figure the amount to enter on line 5.				
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. ☑ **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

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 AOC and lifetime learning credit, the taxpayer should utilize the incentive that provides the most advantageous tax treatment. This choice becomes increasingly complex when the taxpayer has more than one dependent college student. Claiming a tuition and fees deduction for one of the dependent students will usually reduce the taxpayer's AGI. This may result in a larger AOC or lifetime learning 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 their return. Taxpayers may have to repay the deduction when this occurs. Repayment is accomplished by reporting the amount refunded or the tax-free educational assistance received on the line for "Other income" when filing the Form 1040 for the year in which the refund or assistance was received. An example of this situation is shown later in this chapter.

SECTION 529 PLANS

Section 529 is the 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 an eligible 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 eligible educational institutions frequently hire investment firms or mutual fund companies to manage their §529 plans.

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

- Contributions to the plan must be made in cash[27] ("cash" includes checks, money orders, credit cards, or electronic transfers from banks or investment accounts).
- The plan must provide separate accounting for each designated beneficiary.[28]
- Neither the account owner nor the beneficiary is allowed to direct the investment of the account.[29] 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.[30]
- The plan must have adequate safeguards in place to prevent contributions greater than what is reasonably expected to be necessary for the beneficiary's higher education expenses.[31]

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).[32]

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, and they 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 a contingent or successor account owner.

27. IRC §529(b)(2).
28. IRC §529(b)(3).
29. IRC §529(b)(4).
30. IRC §529(b)(5).
31. IRC §529(b)(6).
32. Prop. Treas. Reg. §1.529-1(c).

BENEFICIARY

When a §529 plan is established, **a single designated beneficiary must be identified.**[33] 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 $13,000 federal annual gift tax exclusion.[34] 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 ($65,000 for individuals and $130,000 for split gifts) without gift tax consequences.[35]

If the donor dies during the 5-year period, the donor's estate includes on the gift tax return only that portion of the contributions allocable to years after the donor's death.[36]

> **Example 9.** In 2010, Grandma Jones contributes $65,000 to a §529 plan naming her grandson, Rob, as beneficiary. She elects to prorate this contribution over five years on her 2010 gift tax return.
>
> In 2011, Grandma gives Rob $2,000 cash. This is a taxable gift because her $13,000 annual exclusion was used by the 2010 §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 is no federal income tax consequence on beneficiary changes to qualified family members, nor is there any gift tax consequence unless the new beneficiary is in a younger generation than the prior beneficiary.[37]

> **Example 10.** Use the same facts as **Example 9.** Grandma Jones' §529 plan has an account balance of $75,000, which includes $65,000 of contributions and $10,000 of earnings. In 2011, Grandma decides to change the account's beneficiary. Her grandson Rob was arrested for DUI and Grandma wants nothing to do with him.
>
> Grandma names her granddaughter, Rebecca, as beneficiary of the §529 plan. There are no income or gift tax consequences on this beneficiary change because Rebecca is in the same generation as Rob.

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.[38] This gift is eligible for the special 5-year proration.[39]

> **Example 11.** Use the same facts as **Example 10,** 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 2011 to David.[40] The total gift is $75,000 ($65,000 contributions + $10,000 earnings). The 5-year proration is $65,000 ($13,000 × 5). The taxable gift is deemed to be $10,000 ($75,000 – $65,000).

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33. IRC §529(e)(1).
34. IRC §529(c)(2)(A)(i).
35. IRC §529(c)(2)(B).
36. IRC §529(c)(4)(C).
37. IRC §529(c)(5)(B).
38. Prop. Treas. Reg. §1.529-5(b)(3)(ii).
39. IRC §529(c)(5)(B).
40. Treas. Reg. §1.529-5.

TYPES OF §529 PLANS

There are two types of §529 plans: **prepaid tuition programs** and **college savings plans.**[41] State-established programs can provide either a prepaid tuition program or a college savings plan. Programs established by an educational institution can provide only prepaid tuition programs.[42]

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.

College Savings Plans

Under a college savings plan, the account holder 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 college savings plans can be used for all college expenses, not just tuition and fees. As with prepaid tuition programs, the terms, conditions, and limits vary by state.

DISTRIBUTIONS

Two tax consequences may arise from QTP distributions:

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

41. [www.sec.gov/investor/pubs/intro529.htm] Accessed on Nov. 16, 2010.

42. [www.collegesavings.org/whatIs529.aspx] Accessed on Nov. 16, 2010.

Qualified Distributions

Qualified distributions from a §529 plan are distributions spent on QHEE.[43] 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[44]
- Room and board if the student is enrolled at least half time. Room and board expenses allowed in calculating QHEE are:
    - The allowance for room and board that the educational institution uses in the cost of attendance for federal financial aid purposes, or
    - The actual amount paid to the eligible educational institution for room and board, if greater.[45]
- Special needs services required by special needs students[46]

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

- Tax-free scholarships and fellowships
- Other nontaxable payments received for educational expenses such as the following:
    - Veterans' educational assistance benefits
    - Qualified tuition reductions
    - Employer-provided educational assistance

Example 12. In 2010, 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. Because the $10,000 distribution from Sally's §529 plan is not greater than her QHEE, there is no federal income tax on the distribution.

Nonqualified Distributions

A nonqualified distribution is any distribution that is not a qualified distribution. The account owner must pay tax plus a 10% penalty on the earnings portion of the distribution.[47]

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

Example 13. Olivia opened a college savings plan many years ago with high hopes for her son, Tom. In 2011, 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 cannot use 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 2011 Form 1040, line 21 as "Other income." In addition, she will owe the 10% penalty of $200. Part II of Form 5329 is used to compute the penalty, as shown here.

Form **5329**
Department of the Treasury
Internal Revenue Service (99)

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

▶ Attach to Form 1040 or Form 1040NR.

▶ See separate instructions.

OMB No. 1545-0074
2011
Attachment Sequence No. 29

Name of individual subject to additional tax. If married filing jointly, see instructions.	Your social security number
Olivia	999-88-7777

Fill in Your Address Only If You Are Filing This Form by Itself and Not With Your Tax Return ▶		
	Home address (number and street), or P.O. box if mail is not delivered to your home: 2700 Baird Drive	Apt. no.
	City, town or post office, state, and ZIP code: Zunesville, OH 43000	If this is an amended return, check here ▶ ☐

If you **only** owe the additional 10% tax on early distributions, you may be able to report this tax directly on Form 1040, line 58, or Form 1040NR, line 56, without filing Form 5329. See the instructions for Form 1040, line 58, or for Form 1040NR, line 56.

Part I Additional Tax on Early Distributions

Complete this part if you took a taxable distribution before you reached age 59½ from a qualified retirement plan (including an IRA) or modified endowment contract (unless you are reporting this tax directly on Form 1040 or Form 1040NR—see above). You may also have to complete this part to indicate that you qualify for an exception to the additional tax on early distributions or for certain Roth IRA distributions (see instructions).

1	Early distributions included in income. For Roth IRA distributions, see instructions	1	
2	Early distributions included on line 1 that are not subject to the additional tax (see instructions). Enter the appropriate exception number from the instructions: ______	2	
3	Amount subject to additional tax. Subtract line 2 from line 1	3	
4	**Additional tax.** Enter 10% (.10) of line 3. Include this amount on Form 1040, line 58, or Form 1040NR, line 56	4	
	Caution: *If any part of the amount on line 3 was a distribution from a SIMPLE IRA, you may have to include 25% of that amount on line 4 instead of 10% (see instructions).*		

Part II Additional Tax on Certain Distributions From Education Accounts

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

5	Distributions included in income from Coverdell ESAs and QTPs	5	2,000
6	Distributions included on line 5 that are not subject to the additional tax (see instructions)	6	
7	Amount subject to additional tax. Subtract line 6 from line 5	7	2,000
8	**Additional tax.** Enter 10% (.10) of line 7. Include this amount on Form 1040, line 58, or Form 1040NR, line 56	8	200

Part III Additional Tax on Excess Contributions to Traditional IRAs

When a nonqualified distribution is made because of 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 is waived.[48]

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

48. IRS Pub. 970, *Tax Benefits for Education*.

Example 14. Kwan Lu receives a $6,000 scholarship after a distribution of $11,000 was made from a §529 plan. Form 1099-Q, *Payments from Qualified Education Programs (Under Sections 529 and 530),* shows that the distribution includes $9,000 of return of contributions (box 3) 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** **99 Government St.** **Springfield, IL 62222**	1 Gross distribution $ **11000.00** 2 Earnings $ **2000.00**	OMB No. 1545-1760 **2010** 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 **Kwan Lu** Street address (including apt. no.) **444 Schoolhouse Rd** City, state, and ZIP code **University Place, IL 61111** Account number (see instructions)	5 Check one: • Qualified tuition program— Private ☐ or State ☒ • Coverdell ESA ☐ If the fair market value (FMV) is shown below, see **Pub. 970,** Tax Benefits for Education, for how to figure earnings.	6 If this box is checked, the recipient is not the designated beneficiary ☐	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

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

AQEE = $11,000 QHEE – $6,000 scholarship = $5,000

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

Taxable QTP = $2,000 earnings – $909 tax-free earnings = $1,091

Kwan received QTP distributions of $11,000 and his QHEE was also $11,000; therefore, the 10% penalty does not apply. However, Kwan must include $1,091 as taxable income on his Form 1040, line 21 (other income). If Kwan'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 or a qualified member of the beneficiary's family is considered a rollover rather than a distribution.[49] The rollover treatment only applies to one transfer within any 12-month period for the same beneficiary.[50]

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.

49. IRC §529(c)(3)(C)(i).

50. IRC §529(c)(3)(C)(iii).

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.[51]

- Spouse
- Child or descendant of the child
- Brother, sister, stepbrother, or stepsister
- Father, mother, or ancestor of either
- Stepfather or stepmother
- 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

EVALUATING A §529 PLAN

Many clients consult their tax preparers for suggestions and advice regarding §529 plans. In deciding which plan is best for a client, many factors, including the ages of the children and the client's financial situation, must be considered. The following information should be carefully evaluated.

- The plan offered by the state in which the taxpayer resides (Many states offer state income tax benefits for investing in their plan.)
- Plans offered by other states that do not have a residency requirement
- The latest information for the plans under consideration (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.)

The following 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

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 website compares the various state plans and answers many questions a taxpayer may have regarding the plans.

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51. IRC §529(e)(2).

COVERDELL EDUCATION SAVINGS ACCOUNTS

A Coverdell ESA is a trust exclusively for the purpose of paying qualified education expenses for the designated beneficiary of the trust.[52] These accounts were formerly known as Education IRAs.

To be treated as a Coverdell ESA, the account must be designated as a Coverdell ESA when it is created.[53]

Distributions from a Coverdell ESA can be applied not only to higher education expenses but also to elementary and secondary education expenses.

> **Note.** A provision in EGTRRA allowed distributions from Coverdell ESAs to be applied to elementary and secondary education expenses as well as higher education expenses. This feature was set to expire at the end of 2010 but was extended through December 31, 2012, by a provision in the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010.

CONTRIBUTIONS

Contributions to Coverdell ESAs are not deductible. The contribution is treated as a completed gift to the beneficiary which qualifies for the annual gift tax exclusion.[54]

Currently, annual contributions may not exceed $2,000 **per beneficiary** and may not be made once the beneficiary reaches the age of 18.[55] Contributions are allowed for special needs beneficiaries without regard to the age limitation.[56] Additionally, contributions must be made by the **unextended due date** of the return (i.e., April 15 for most taxpayers).[57]

There is no limit on the number of Coverdell ESAs that can be established for a designated beneficiary; the limit is on the total annual contributions to all Coverdell ESAs for a designated beneficiary.

Example 15. When Chantelle was born in 2008, three separate Coverdell ESAs were set up for her. One was established by her parents, one by her grandparents, and one by her aunt. In 2011, the total of all contributions to Chantelle's three Coverdell ESAs cannot be more than $2,000. Therefore, if her parents contribute $2,000 to one of her Coverdell ESAs, no one else can contribute to any of her three accounts. Alternatively, if her parents contribute $1,000 and her aunt $600, her grandparents or someone else can contribute no more than $400. These contributions can be made to any of Chantelle's Coverdell ESAs.[58]

> **Note.** Custodians of Coverdell ESAs inform the IRS annually on Form 5498 of contributions made for the benefit of each beneficiary in the prior year.

Example 16. Use the same facts as **Example 15.** Chantelle's older brother, Wade, also has a Coverdell ESA. If their parents contribute $2,000 to Chantelle's Coverdell ESA in 2011, they can also contribute $2,000 to Wade's Coverdell ESA.

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52. IRC §530(b)(1).
53. Ibid.
54. IRC §530(d)(3).
55. IRC §530(b)(1(A).
56. IRC §530(b)(1).
57. IRC §530(b)(4).
58. IRS Pub. 970, *Tax Benefits for Education*.

INCOME LIMITATIONS

Contributions to Coverdell ESAs are phased out based on the MAGI of the donors.[59] The following table shows the 2011 limits.

Filing Status	2011 MAGI Phaseout Range [60]
MFJ	$190,000–220,000
All others	95,000–110,000

MAGI is AGI with the following additions:[61]

- Foreign earned income and housing exclusions and deductions
- Exclusion of income by bona fide residents of American Samoa or Puerto Rico

> **Observation.** There are no restrictions regarding who can contribute to a Coverdell ESA. Accordingly, a taxpayer whose income is too high can gift the contribution amount to an eligible person who can then make a contribution to the beneficiary's Coverdell.

Corporations and other entities can make contributions to Coverdell ESAs, regardless of the income of the business during the year of contribution.[62]

EXCESS CONTRIBUTIONS

The **beneficiary** is subject to a 6% excise tax on excess contributions that are in a Coverdell ESA at the end of the year. The excise tax does not apply if the excess contributions and earnings thereon are distributed before the beginning of the sixth month following the year of contribution. This means calendar-year taxpayers have until May 31 to withdraw any excess contributions. However, the distributed earnings must be included in gross income for the year in which the excess contribution was made.

Excess contributions are defined as the total of the following two amounts.[63]

1. Amounts contributed to a beneficiary's account(s) in excess of the $2,000 annual contribution limit (or amounts contributed in excess of the maximum contribution limit based on the contributor's income for the year, if less)
2. Excess contributions remaining in the Coverdell ESA from preceding years, reduced by both of the following:
   a. Distributions during the year (not including rollovers), and
   b. The contribution limit for the current year minus any amount contributed for the current year.

The excise tax applies to each year the excess contribution remains in the Coverdell ESA and not just for the year in which the excess contribution was made.

59. IRC §530(c)(1).

60. Joint Committee on Taxation, Technical Explanation of the Revenue Provisions Contained in the "Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010" Scheduled for Consideration by the United States Senate (JCX-55-10), Dec. 10, 2010.

61. IRS Pub. 970, *Tax Benefits for Education*.

62. Ibid.

63. Ibid.

Example 17. Rafael's parents and grandparents contributed a total of $2,300 to Rafael's Coverdell ESA in 2010 — an excess contribution of $300. Because Rafael did not withdraw the excess before June 1, 2011, he had to pay an additional tax of $18 ($300 × 6%). If he already filed his 2010 tax return, he must complete and file Form 5329 to pay the additional tax.

Note. Rafael reports the excise tax in Part V of Form 5329, *Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts.*

In 2011, excess contributions of $500 were made to Rafael's account; however, he withdrew $250 from the account to use for qualified education expenses. Rafael figures the excess contribution in his account at the end of 2011 as follows:

Excess contributions made in 2011	$500
Excess contributions in ESA at end of 2010	300
Less: distribution made in 2011	(250)
Excess at end of 2011	$550
Excise tax rate	× 6%
Additional tax due	$ 33

If Rafael limits 2012 contributions to $1,450 ($2,000 maximum – $550 excess contributions from 2011), he will not owe any additional tax in 2012 for excess contributions.

The excise tax does not apply to any rollover contributions.

DISTRIBUTIONS

A designated beneficiary of a Coverdell ESA can take a distribution at any time. To be tax free, distributions from Coverdell ESAs must not exceed the amount of AQEE. AQEE is calculated by reducing qualified education expenses by any tax-free educational assistance. Tax-free educational assistance includes the following.[64]

- Tax-free scholarships and fellowships
- Veterans' educational assistance benefits
- Pell grants
- Employer-provided educational assistance
- Any other nontaxable payments received as educational assistance

The balance in the Coverdell ESA must be withdrawn within 30 days after the earlier of:

- The beneficiary reaching age 30, unless the individual is a special needs beneficiary, or
- The beneficiary's death.

64. IRS Pub. 970, *Tax Benefits for Education*.

The earnins portion of a distribution not spent on qualifying educational expenses is subject to a 10% additional tax.[65] However, the 10% additional tax does not apply in the following circumstances.[66]

- The distribution was made on or after the **death** of the designated beneficiary.
- The distribution was attributable to the **disability** of the designated beneficiary.
- The distribution was made because the designated beneficiary received a **qualified scholarship** that was excluded from income if the amount of the distribution does not exceed the amount of the scholarship.
- Part of a distribution from a Coverdell was taxable only because tax-free treatment was waived in order to **claim an education credit.**
- The distribution was made because of the designated beneficiary's attendance at the **U.S. Military Academy, Naval Academy, Air Force Academy, Coast Guard Academy, or Merchant Marine Academy,** if the amount of the distribution did not exceed the costs of the education attributable to such attendance.

COMPUTATION OF TAXABLE DISTRIBUTIONS

The taxable portion of a distribution is the earnings portion of any distribution not spent on qualified education expenses. This amount is computed as follows.[67]

Step 1. Multiply the total distribution by a fraction. The numerator of the fraction is the basis (contributions not previously distributed) at the end of the previous year plus total contributions for the current year. The denominator of the fraction is the total account balance at the end of the current year plus the amount distributed during the year.

Step 2. Subtract the amount calculated in Step 1 from the total current year distribution. The result is the amount of earnings included in the total distribution.

Step 3. Multiply the total earnings from Step 2 by a fraction. The numerator of the fraction is the AQEE paid during the year. The denominator of the fraction is the total amount distributed during the year.

Step 4. Subtract the amount calculated in Step 3 from the amount of earnings calculated in Step 2. The result is the amount the beneficiary must include in income.

Example 18. Brandi received an $850 distribution from her Coverdell ESA in 2011. There were no contributions to her Coverdell ESA account in 2011, but $1,500 had been contributed before 2011. This is her first distribution from the account, so her basis in the account on December 31, 2010, was $1,500. The balance of her account on December 31, 2011, is $950. Brandi had $700 of AQEE for 2011. Brandi calculates the taxable portion of her distribution as follows:

Step	Calculation	Result	
1	$\$850 \text{ distribution} \times \frac{\$1{,}500 \text{ basis} + \$0 \text{ contribution}}{\$950 \text{ value} + \$850 \text{ distribution}}$	$708	(basis)
2	$850 distribution − $708 basis	142	(earnings)
3	$\$142 \text{ earnings} \times \frac{\$700 \text{ AQEE}}{\$850 \text{ distribution}}$	117	(tax-free earnings)
4	$142 earnings − $117 tax-free earnings	25	(taxable earnings)

On her 2011 tax return, Brandi must include $25 in income as distributed earnings that were not used for qualified education expenses. She reports this amount as other income on Form 1040, line 21, listing the type and amount of income on the dotted line.

65. IRC §530(d)(4)(A).

66. IRC §530(d)(4)(B).

67. IRS Pub. 970, *Tax Benefits for Education*.

QUALIFIED EDUCATION EXPENSES

Qualified higher education expenses relate to enrollment or attendance at an eligible postsecondary school. These include the following.

1. Tuition, fees, books, supplies, and equipment if required for enrollment or attendance of a designated beneficiary at an eligible school
2. Expenses for special needs services incurred in connection with enrollment or attendance at an eligible school
3. Expenses for room and board for students attending at least half time, if the amount does not exceed the greater of the following two amounts:
   a. The room and board allowance used by the educational institution in calculating the cost of attendance for federal financial aid purposes
   b. The actual amount charged if the student resides in housing owned or operated by the school

Qualified higher education expenses also include any amounts contributed to a §529 plan for the benefit of the account beneficiary. **Coverdell ESAs can be rolled into §529 plans, but §529 plans cannot be rolled into Coverdell ESAs.** The earnings portion of the Coverdell ESA is not considered part of the basis in the §529 plan.

Qualified elementary and secondary education expenses include the following.[68]

- Expenses for tuition and fees, academic tutoring, special needs services, books, supplies, and other equipment incurred in connection with the enrollment or attendance of the designated beneficiary at a public, private, or religious school
- Expenses for room and board, uniforms, transportation, and supplementary items and services which are required or provided by a public, private, or religious school in connection with enrollment or attendance
- Expenses for the purchase of computer technology, equipment, or Internet access and related services if used by the beneficiary and the beneficiary's family during the years of schooling (not including software designed for sports, games, or hobbies unless the software is predominantly educational in nature)

> **Observation.** The definition of qualified elementary and secondary education expenses for Coverdell ESAs is extremely taxpayer friendly. For example, a distribution can be used to fund a home computer used by the entire beneficiary's family.

ELIGIBLE EDUCATIONAL INSTITUTION

An eligible educational institution can be either an eligible postsecondary school or an eligible elementary or secondary school.

An eligible postsecondary school is an accredited college, university, vocational school, or other postsecondary educational institution eligible to participate in the U.S. Department of Education student aid programs.[69]

For elementary and secondary school expenses, an eligible educational institution is any public, private, or religious school providing elementary or secondary education (kindergarten through grade 12) as determined under state law.[70]

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68. IRC §530(b)(3)(A).
69. IRS Pub. 970, *Tax Benefits for Education*.
70. Ibid.

ROLLOVERS AND BENEFICIARY CHANGES

Assets can be rolled over from one Coverdell ESA to another for the same designated beneficiary. The designated beneficiary can be changed to another qualifying member of the family.

Assets distributed from a Coverdell ESA are not taxable if they are rolled over to another Coverdell ESA for either the same designated beneficiary or a qualifying member of the family who is under age 30. The age limitation does not apply if the new beneficiary is a special needs individual.

A distributed amount is rolled over if it is paid to another Coverdell ESA within 60 days after the date of the distribution. Qualifying rollovers are **not** reported anywhere on Form 1040.

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.

- Spouse
- Son, daughter, stepchild, foster child, adopted child, or a descendant of any of them
- Brother, sister, stepbrother, or stepsister
- Father, mother, or ancestor of either
- Stepfather or stepmother
- 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

HIGHER EDUCATION REPORTING FORMS

BACKGROUND

The Taxpayer Relief Act of 1997 added IRC §6050S. This stipulated that eligible educational institutions 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 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.[71]

In 2002, the IRS issued final regulations describing the reporting requirements for educational institutions.[72] Form 1098-T, *Tuition Statement,* was created to report information to the IRS and to the taxpayer.

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

72. TD 9029, 2003-1 CB 403.

FORM 1098-T

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

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

The second problem is that not all students receive Forms 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.

The taxpayer's credit or deduction is computed using **the amounts actually paid during the tax year.** 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 reported in boxes 1 and 2 may be different than what was actually paid. This information is best obtained from the detailed bills from the educational institution, not from the Form 1098-T.

☐ 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 2010 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 2010 ☐		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 2011 ► ☐	
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 — Amounts 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.

Example 19. Sasha attends Quincy University, where tuition and fees are $2,000 per semester. Quincy University bills Sasha $2,000 in August 2010 for the fall semester, and $2,000 in December 2010 for the 2011 spring semester. Quincy University sends Sasha a completed 2010 Form 1098-T showing $4,000 in **box 2** as amounts billed for qualified tuition and fees.

Sasha pays the tuition in the same months she was billed (August and December 2010). **She computes her 2010 education deduction or credit on the entire $4,000 she paid in 2010.**

If Sasha instead paid the tuition for the 2011 spring semester in January 2011, she computes her 2010 education deduction or credit on $2,000 only. This is the amount she paid in 2010. The $2,000 billed in December 2010 and paid in January 2011 will be used to compute her education deduction or credit for 2011.

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

Example 20. Use the same facts as **Example 19.** Quincy University bills Sasha $2,000 in August 2010 for the fall semester and $2,000 in December 2010 for the 2011 spring semester.

Sasha paid her fall 2010 tuition in August 2010. She paid her spring 2011 tuition in January 2011. She paid her fall 2011 tuition in August 2011 and her spring 2012 tuition in December 2011.

Quincy University sends Sasha a completed Form 1098-T for 2011 with **box 3** checked. The $6,000 of payments **received** is reported in **box 1.**

Box 4 — Adjustments Made for Prior Year. This box shows any adjustments (such as refunds or reductions in charges) 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's tuition is paid is treated as a refund. The taxpayer reduces the amount of eligible expenses when a refund is received in the same year expenses are paid or in the following year **prior to the time the return is filed.**[73]

Example 21. In August 2010, Mariana Santos pays $2,000 tuition and fees to the local community college as a full-time student for the fall semester. Prior to beginning classes, she withdraws from some of the classes. This changes her status to three-fourths time. In January 2011, Mariana receives a refund of $500 from the college.

To compute her AOC for 2010, Mariana must reduce the $2,000 tuition paid by the $500 refund received. Her net result is $1,500 of qualified education expenses for 2010, for a maximum credit of $1,500. The first page of Mariana's Form 8863 follows.

The 2010 Form 1098-T Mariana 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, Mariana will also receive a 2011 Form 1098-T showing $500 in box 4 (adjustment for prior year).

73. Treas. Reg. §1.25A-5(f)(1).

For Example 21

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

Education Credits (American Opportunity and Lifetime Learning Credits)

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

OMB No. 1545-0074 — 2010 — Attachment Sequence No. 50

Name(s) shown on return: **Mariana Santos** — Your social security number: **444-55-6666**

CAUTION *You cannot take both an education credit and the tuition and fees deduction (see Form 8917) for the same student for the same year.*

Part I American Opportunity Credit

Caution: *You cannot take the American opportunity credit for more than 4 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 $4,000 for each student.	(d) Subtract $2,000 from the amount in column (c). If zero or less, enter -0-.	(e) Multiply the amount in column (d) by 25% (.25)	(f) If column (d) is zero, enter the amount from column (c). Otherwise, add $2,000 to the amount in column (e).
	Mariana Santos	444-55-6666	1,500	0	0	1,500

2 **Tentative American opportunity credit.** Add the amounts on line 1, column (f). If you are taking the lifetime learning credit for a different student, go to Part II; otherwise, go to Part III . . . . . . ▶ 2 — 1,500

Part II Lifetime Learning Credit

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

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). If you have an entry on line 2, go to Part III; otherwise go to Part IV	6	

For Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 25379M Form **8863** (2010)

An amended return is **not** required for taxpayers who receive a refund after filing their returns. Taxpayers who claimed one of the **education tax credits** must increase their tax for the following year by the prior year's credit claimed which was 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 reduced qualified expenses. That amount is included as an additional tax in the year the refund is received. The amount and the notation "ECR" should be entered in the space next to line 44 ("tax") of Form 1040.[74]

Example 22. Use the same facts as **Example 21,** except Mariana does not receive the refund until May 2011. She timely filed her 2010 return, and claimed an AOC for the entire $2,000 tuition payment.

American opportunity credit as reported on Mariana's 2010 tax return	$2,000
Less: American opportunity credit as recomputed after refund	(1,500)
Additional tax reported on her 2011 Form 1040, line 44, with the notation "ECR"	$ 500

[74] Form 1040 Instructions.

Taxpayers who claim the **tuition and fees deduction** and then receive a refund after their return is filed increase their income in the following year by the refunded amount to the extent that it reduced their 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 23. Use the same facts as **Example 22,** except Mariana claimed the tuition and fees deduction in 2010.

Tuition and fees deduction as reported on Mariana's 2010 tax return	$2,000
Less: tuition and fees deduction as recomputed after refund	(1,500)
Additional income reported on her 2011 Form 1040, line 21 (other income)	$ 500

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 24. 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 allow 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 25. Use the same facts as **Example 24,** 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 line 7 of her Form 1040 with the notation "SCH."[75] Shaneese does not need to reduce the $3,000 tuition by the scholarship to calculate her education deduction or credit.

Box 6 — Adjustments to Scholarships or 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 may claim 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 does not meet the 2% of AGI limitation.

Example 26. Marcos received a $15,000 taxable grant from Sun State University in **2009.** This amount was properly reported as a taxable scholarship on his 2009 return. Marcos claimed the standard deduction and paid $568 of income tax on the grant. In **2010,** the grant was reduced by $2,000. Because Marcos does not itemize, he cannot obtain any tax benefit on his 2010 return.

75. Ibid.

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 (under the "Claim of Right" doctrine) 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 71 (2010), with the notation "IRC 1341" next to the line.

Example 27. Use the same facts as **Example 26,** except in **2010** the grant was reduced by $4,000. Marcos has two options. Because he does not itemize, he chooses the tax credit option.

Marcos recomputes his 2009 tax as if the taxable grant were only $11,000. His recomputed tax liability is now $166. Marcos claims a tax credit on his 2010 return for $402 (the difference between the $568 original tax and the $166 recomputed tax).

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 28. In 2010, Cari's tuition and fees were $5,000. Cari received a $4,000 scholarship, which she treated as nontaxable. Cari claimed a tuition and fees deduction on the remaining $1,000.

In 2011, Cari's $4,000 scholarship for 2010 was retroactively reduced to only $2,000. Cari may amend her 2010 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 of the subsequent tax 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 AOC, this 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. If the educational institution agrees that the original Form 1098-T was erroneous, it should issue a new Form 1098-T with an "X" entered in the "CORRECTED" box at the top of the form.

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.[76] 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[77]
- Contributions to a Coverdell 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.)[78]
- 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.)[79]

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[80]
- Expenses used to compute tax-free withdrawals from Coverdell ESAs[81]
- Expenses used to compute tax-free withdrawals from §529 plans[82]
- Expenses used to compute the AOC or lifetime learning credit[83]
- Any other nontaxable payments received for educational expenses, including the following:
    - Veterans' educational assistance benefits
    - Qualified tuition reductions
    - Employer-provided educational assistance[84]

76. IRC §135(a); Form 8815 Instructions.
77. IRC §135(c)(2)(A).
78. IRC §135(c)(2)(C).
79. Ibid.
80. IRC §135(d)(1).
81. IRC §135(d)(2)(B).
82. Ibid.
83. IRC §135(d)(2)(A).
84. IRC §135(d)(1).

Income Limitations

The interest exclusion is phased out for higher-income taxpayers based on MAGI.[85] MAGI is AGI with the following additions.[86]

- Foreign earned income and housing exclusions and deductions
- Exclusion of income from Guam, American Samoa, the Northern Mariana Islands, or Puerto Rico
- Exclusion for adoption benefits received under an adoption assistance program
- Deduction for domestic production activities
- Deduction for student-loan interest
- Deduction for tuition and fees

2011 U.S. Savings Bond Interest Exclusion Income Limitations[87]

Filing Status	MAGI Phaseout Range
MFJ, QW	$106,650–136,650
Single, HoH	71,100– 86,100
MFS	N/A

Example 29. Marshall and Gwenella have a daughter, Sophia. In 1997, when she was three years old, Marshall and Gwenella purchased Series EE and I savings bonds to save for her education. In 2010, Marshall anticipated his MAGI would be $100,000 for the year, which is in the range where the interest income is excluded if it is spent on qualifying educational expenses.

Gwenella decides she will return to work in 2011. She anticipates that she will earn $40,000. As a result, Marshall and Gwenella's joint 2011 MAGI will be $140,000. Therefore, all the interest from the Series EE and I bonds will be included in their 2011 income even if it is spent on qualifying educational expenses.

In 2010, Marshall and Gwenella decided 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 included $50,000 of principal and $10,000 of interest. Because their 2010 income was still below the phaseout range, Marshall and Gwenella treated the §529 plan contribution as an allowable educational expense for their 2010 interest exclusion.

If they waited to cash the savings bonds until 2011, when Gwenella returned to work, they would not qualify for the interest exclusion.

Following are Marshall and Gwenella's 2010 Form 8815 and Schedule B. Note that the name and address of the financial institution that holds the §529 (QTP) account are entered on line 1, column b.

85. IRC §135(b)(2).

86. IRC §135(c)(4).

87. Rev. Proc. 2010-40, 2010-46 IRB 665.

For Example 29

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

2010

Attachment Sequence No. **167**

Name(s) shown on return	Your social security number
Marshall and Gwenella	333-22-1111

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	QTP First Bank of Anywhere Anywhere, IL

If you need more space, attach a statement.

2	Enter the total qualified higher education expenses you paid in 2010 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 2010 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 2010**			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	100,000		
	Note: *If line 9 is $85,100 or more if single or head of household, or $135,100 or more if married filing jointly or qualifying widow(er) with dependent child,* ***stop.*** *You* ***cannot*** *take the exclusion.*				
10	Enter: $70,100 if single or head of household; $105,100 if married filing jointly or qualifying widow(er) with dependent child	10	105,100		
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) with dependent child. 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 1040A or Form 1040), line 3 ▶			14	10,000

General Instructions

Section references are to the Internal Revenue Code.

Purpose of Form

If you cashed series EE or I U.S. savings bonds in 2010 that were issued after 1989, you may be able to exclude from your income part or all of the interest on those bonds. Use this form to figure the amount of any interest you may exclude.

Who Can Take the Exclusion

You can take the exclusion if all four of the following apply.

1. You cashed qualified U.S. savings bonds in 2010 that were issued after 1989.
2. You paid qualified higher education expenses in 2010 for yourself, your spouse, or your dependents.
3. Your filing status is any status except married filing separately.
4. Your modified AGI (adjusted gross income) is less than: $85,100 if single or head of household; $135,100 if married filing jointly or qualifying widow(er) with dependent child. See the instructions for line 9 to figure your modified AGI.

U.S. Savings Bonds That Qualify for Exclusion

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

Recordkeeping Requirements

Keep the following records to verify interest you exclude.

- Bills, receipts, canceled checks, or other documents showing you paid qualified higher education expenses in 2010.
- A written record of each post-1989 series EE or I bond that you cash. Your record must include the serial number, issue date, face value, and total redemption proceeds (principal and interest) of each bond. You can use Form 8818, Optional Form To Record Redemption of Series EE and I U.S. Savings Bonds Issued After 1989, as your written record.

For Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 10822S Form **8815** (2010)

For Example 29

SCHEDULE B
(Form 1040A or 1040)
Department of the Treasury
Internal Revenue Service (99)

Interest and Ordinary Dividends

▶ **Attach to Form 1040A or 1040.** ▶ **See instructions on back.**

OMB No. 1545-0074
2010
Attachment Sequence No. **08**

Name(s) shown on return: **Marshall and Gwenella**
Your social security number: **333-22-1111**

				Amount
Part I Interest (See instructions on back and the instructions for Form 1040A, or Form 1040, line 8a.) **Note.** If you received a Form 1099-INT, Form 1099-OID, or substitute statement from a brokerage firm, list the firm's name as the payer and enter the total interest shown on that form.	1	List name of payer. If any interest is from a seller-financed mortgage and the buyer used the property as a personal residence, see instructions on back and list this interest first. Also, show that buyer's social security number and address ▶ **Three State Bank (Series EE and I bonds)**	1	10,000
	2	Add the amounts on line 1	2	10,000
	3	Excludable interest on series EE and I U.S. savings bonds issued after 1989. Attach Form 8815	3	10,000
	4	Subtract line 3 from line 2. Enter the result here and on Form 1040A, or Form 1040, line 8a ▶	4	0

Note. If line 4 is over $1,500, you must complete Part III. — Amount

EDUCATION LOANS

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, federal loans are the largest form of student aid, making up 49% of the total financial aid awarded in 2009–2010.[88]

The Taxpayer Relief Act of 1997 added IRC §221. 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.[89]

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, if a taxpayer's 2011 MAGI is less than $75,000 ($150,000 for MFJ), a special deduction is allowed for interest paid on an education loan used for higher education.[90]

88. [http://trends.collegeboard.org/student_aid/report_findings/indicator/Total_Student_Aid_by_Source] Accessed on Nov. 19, 2010.

89. IRC §221(d)(1).

90. Rev. Proc. 2011-12, 2011-2 IRB 300.

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. This deduction is taken as an adjustment to AGI; consequently, even taxpayers who do not itemize can benefit from it.

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.[91] 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 in a program leading to a degree, certificate, or other recognized educational credential.[92]

In addition to simple interest on the loan, other items can be considered **education loan interest.**[93]

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

Example 30. Ethan has a qualified education loan. He is a full-time student and is not required to make payments until after he graduates. Ethan 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 MFS.
- 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 receiving the payment from the third party and, in turn, paying the interest.[94] The third-party payment is treated as a gift made by the third party to the taxpayer.

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91. Treas. Reg. §1.221-1(e)(3)(iv).
92. IRS Pub. 970, *Tax Benefits for Education*.
93. Ibid.
94. Treas. Reg. §1.221-1(b)(4)(i).

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 before taking any deduction for student loan interest with the following additions.

- Foreign earned income and housing exclusions and deductions
- Exclusion of income by residents of Guam, American Samoa, the Northern Mariana Islands, or Puerto Rico
- The domestic production activities deduction
- The tuition and fees deduction[95]

2011 Phaseout of Deductions for Education Loan Interest[96]

Filing Status	MAGI Phaseout Range
MFJ	$120,000–150,000
Single, HoH, QW	60,000– 75,000
MFS	N/A

For taxpayers with MAGI that falls within the phaseout range, 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 – $60,000 or $120,000 for MFJ) ÷ $15,000 or $30,000 for MFJ.

Step 3. Subtract the amount calculated in Step 2 from the amount determined in Step 1.[97]

Example 31. Jeannette files her 2010 tax return as MFJ. She paid $800 interest on a qualified student loan. The MAGI for her and her husband is $140,000. Jeannette's deduction is calculated as follows:

Step 1. Qualifying interest paid = $800

Step 2. $800 × (($140,000 – $120,000) ÷ $30,000) = $533

Step 3. $800 – $533 = **$267** tax deduction for education loan interest

Example 32. Use the same facts as **Example 31,** except Jeannette paid $2,750 of interest. Jeannette's deduction is calculated as follows:

Step 1. Qualifying interest paid = $2,500 (lesser of qualifying interest paid or $2,500)

Step 2. $2,500 × (($140,000 – $120,000) ÷ $30,000) = $1,667

Step 3. $2,500 – $1,667 = **$833** tax deduction for education loan interest

Note. The MAGI phaseout range for the student loan interest deduction was scheduled to revert to significantly lower pre-EGTRRA levels on December 31, 2010. However, this was delayed by two years (through December 31, 2012) by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010. This legislation also delayed for two years a provision that would limit the deductibility of student loan interest to the first 60 months that interest payments are required.

95. IRC §221(b)(2)(C).

96. Joint Committee on Taxation, Technical Explanation of the Revenue Provisions Contained in the "Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010" Scheduled for Consideration by the United States Senate (JCX-55-10), Dec. 10, 2010.

97. IRS Pub. 970, *Tax Benefits for Education*.

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. It is issued by financial institutions, governmental units, educational institutions, or other persons who receive student loan interest of $600 or more from an individual during the year in the course of a trade or business.

☐ CORRECTED (if checked)

RECIPIENT'S/LENDER'S name, address, and telephone number			OMB No. 1545-1576 2010 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 If checked, box 1 does **not** include loan origination fees and/or capitalized interest for loans made before September 1, 2004 . . . ☐		

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

Box 1 — Student Loan Interest. This is the amount of interest the lender **received** during the calendar year. For loans made after August 31, 2004, loan origination fees and/or capitalized interest must be included in box 1.

Box 2 — Loan Origination Fee Checkbox. A checkmark in this box indicates that loan origination fees and/or capitalized interest are not reported in box 1 for loans made before September 1, 2004.

If loan origination fees are not included in the amount reported on Form 1098-E, any reasonable method can be used to allocate these fees over the term of the loan.[98]

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 (Form W-9S) that the home-equity loan proceeds will be used exclusively for college expenses. Home-equity indebtedness used for education is not deductible for AMT purposes if deducted on Schedule A.

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 an 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 and graduate degree students. They are usually the best student loans available. Perkins loans offer a low fixed-interest rate, no fees, and the best deferment and cancellation provisions.

98. Ibid.

The current interest rate is 5% for Perkins loans.[99] 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 at least a half-time basis.
- The student is suffering economic hardship.
- The student is in an approved graduate fellowship program or an approved rehabilitation training program for the disabled.
- The student is unable to find full-time employment.
- The student is called to active military duty during a war or other military operation.

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

Part or all of Perkins loans **may be partially or fully canceled** for the following reasons.[100]

- 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[101]
- 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 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

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

99. [studentaid.ed.gov/PORTALSWebApp/students/english/campusaid.jsp] Accessed on Nov. 19, 2010.

100. [studentaid.ed.gov/students/publications/student_guide/2009-2010/english/loancancellation.htm] Accessed on Nov. 19, 2010.

101. A list of the current teacher shortage areas is available at [www2.ed.gov/about/offices/list/ope/pol/tsa.html] Accessed on Nov. 19, 2010.

If a Perkins loan was made by a qualified lender and the 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.[102]

Example 33. 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 34. After Jeffrey 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. Jeffrey has $10,000 of additional income to recognize.

Stafford Loans

Stafford loans are the largest source of low-interest loans administered by the U.S. Department of Education. Stafford loans are available under the William D. Ford Federal Direct Loan Program (Direct Loan Program), which provides funds directly from the federal government. The school is responsible for determining the student's eligibility. The loan is repaid to the Department of Education.

Note. Prior to July 1, 2010, Stafford loans were also made by private lenders under the Federal Family Education Loan Program (FFEL Program). As a result of recent legislation, no further loans will be made under the FFEL program.[103]

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

Example 35. Jane, who is still in college, has a $10,000 subsidized Stafford loan and a $10,000 unsubsidized Stafford loan. The interest on her subsidized loan is being paid by the federal government. Jane must either pay the interest on her unsubsidized loan or capitalize it and add it to her loan balance.

The interest rate for federal Stafford loans to undergraduate students disbursed between July 1, 2010 and June 30, 2011 is 4.5% for subsidized loans. The interest rate on subsidized loans first disbursed to undergraduate students between July 1, 2011 and June 30, 2012 is 3.4%.[104] The interest rate on direct subsidized loans to graduate students is fixed at 6.8%.[105] The interest rate for direct unsubsidized loans is fixed at 6.8% for all borrowers.[106]

In addition to interest, federal Stafford loan borrowers are charged loan origination fees. 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.

102. IRC §108(f).

103. Health Care and Education Affordability Reconciliation Act of 2010 (P.L. 111-152), Sec. 2201.

104. [studentaid.ed.gov/PORTALSWebApp/students/english/studentloans.jsp] Accessed on Dec. 3, 2010.

105. Ibid.

106. Ibid.

Deferment of a Stafford loan depends on 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.

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

- The student returned to school on at least a half-time basis.
- The student is suffering economic hardship.
- The student is in an approved graduate fellowship program or an approved rehabilitation training program for the disabled.
- The student is unable to find full-time employment.
- The student is called to active military duty during a war or other military operation.

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 canceled** for the following reasons.[107]

- 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 students under the Direct Loan Program. The PLUS loan program allows parents to borrow up to the full cost of attendance at a college minus any other financial aid for which the family is eligible.

> **Note.** Before July 1, 2010, PLUS loans were also made by private lenders under the FFEL Program. As a result of recent legislation, all new PLUS loans will be made by the U.S. Department of Education under the Direct Loan Program.[108]

The interest rate for PLUS loans disbursed on or after July 1, 2006, is fixed. The current rate is 7.9% for Direct PLUS loans.[109] In addition to interest, PLUS loan borrowers are charged loan fees of 4% of the principal amount of the loan.[110] These fees are deducted from each loan disbursement.

Repayment begins when the loan is fully disbursed. The first payment of interest and principal is due 60 days after the final disbursement. For PLUS loans that were first disbursed on or after July 1, 2008, parents have the option of deferring repayment while the student is enrolled at least half-time and for an additional six months after that. Interest that accrues during these periods will be capitalized if the parent does not pay it during the deferment.[111]

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107. [studentaid.ed.gov/students/publications/student_guide/2009-2010/english/loancancellation.htm] Accessed on Nov. 19, 2010.
108. [studentaid.ed.gov/PORTALSWebApp/students/english/parentloans.jsp] Accessed on Dec. 3, 2010.
109. Ibid.
110. Ibid.
111. Ibid.

Deferment provisions for PLUS loans relate to the parent borrower's circumstances. The borrower will continue to have interest charged during the deferment period. If the interest is not paid, the interest will be capitalized and added to the principal balance of the loan. PLUS loans may be deferred for the following reasons.

- The parent borrower is unable to find employment.
- The parent borrower is experiencing economic hardship.
- The parent borrower is called to active military duty during a war or other military operation.

Part or all of PLUS loans may be canceled for the following reasons.[112]

- 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
- The school falsely certified a borrower's eligibility
- False certification by reason of identity theft
- The school does not make a required return of loan funds to the lender
- The borrower is not in default and has made 120 monthly payments on the loan while employed in a public service job after October 1, 2007

Direct PLUS Loans for Graduate and Professional Degree Students

Direct PLUS loans are available to graduate and professional degree students to help cover education expenses. The terms and conditions applicable to PLUS loans for parents also generally apply to PLUS Loans for graduate and professional students.[113]

SCHOLARSHIPS, FELLOWSHIPS, AND TUITION REDUCTIONS

A scholarship is an award to a student to help finance the student's education. Scholarships available to individual students range from a one-time payment of $100 to payment of the full educational costs for four years of study. A fellowship is an award to an individual to help finance education or research.

TAXATION OF SCHOLARSHIPS AND FELLOWSHIPS

A scholarship or fellowship is exempt from taxation only if **both** of the following conditions are satisfied.[114]

1. The student is a candidate for a degree at an eligible educational institution.
2. The scholarship or fellowship is used to pay qualified education expenses.

112. [studentaid.ed.gov/PORTALSWebApp/students/english/PerkinsLoanCancellation_DischargeSummChart.jsp] Accessed on Dec. 3, 2010.

113. [studentaid.ed.gov/PORTALSWebApp/students/english/PlusLoansGradProfstudents.jsp] Accessed on Dec. 3, 2010.

114. IRS Pub. 970, *Tax Benefits for Education*.

Degree Candidate

A candidate for a degree includes students who:[115]

- Attend a primary or secondary school or pursue a degree at a college or university, or
- Attend an accredited educational institution that is authorized to provide:
  - A program that is acceptable for full credit toward a bachelor's or higher degree, or
  - A training program which prepares students for gainful employment in a recognized occupation.

Eligible Educational Institution

An **eligible educational institution** is one that:[116]

- Maintains a regular faculty and curriculum, and
- Has a regularly enrolled body of students in attendance at the place where it carries on its educational activities.

Example 36. Greta receives a $500 scholarship to take a correspondence course. All students are correspondence students. Greta cannot exclude the $500 scholarship from income because no students are in attendance at the school's place of business.

Qualified Education Expenses

For purposes of tax-free scholarships and fellowships, qualified education expenses are expenses for:[117]

- Tuition and fees required to enroll at or attend an eligible educational institution, and
- Course-related expenses (e.g., fees, books, supplies, and equipment) that are required for all students in the same course of instruction at the eligible educational institution.

Example 37. Darien receives a scholarship from Gonza University. Darien is enrolled in a writing course. Suggested supplies for the writing course include a laptop computer, but students in the course are not required to obtain a laptop. Darien may not treat the cost of a laptop computer as a course-related expense in determining the amount excluded from income as a qualified scholarship.

Amounts used to pay nonqualifying expenses are taxable, even if the expense is a fee that the student must pay to the institution as a condition of enrollment or attendance.

The following expenses are specifically excluded from qualified education expenses.

- Room and board
- Travel
- Research
- Clerical help
- Equipment and other expenses not required for enrollment or attendance at an eligible educational institution

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115. Ibid.

116. Ibid.

117. Ibid.

Example 38. Maria, a degree candidate, received an $8,000 scholarship. Maria used $5,000 for qualified tuition. The remaining $3,000 was used for room and board. Maria can only exclude $5,000 from income as a qualified scholarship. **The $3,000 used for room and board is not excludable and must be included in income.**

The award is excluded from taxation to the extent it is used for qualifying expenses. This applies even though the terms of the award do not specify it must be used for tuition and related expenses. However, if an award specifies it is to be used for purposes other than tuition and related expenses, it cannot be excluded.

Example 39. Bradley, a degree candidate, received a $2,500 scholarship. The scholarship specially designated that $1,000 was for tuition and $1,500 was for room and board. Bradley's tuition for the year is $2,000. The $1,000 specified for tuition is excludable. The remaining $1,500, which was designated for room and board, is **not excludable** and must be included in income.

PAYMENTS FOR SERVICES

Qualified scholarships and fellowships generally do not include any amounts representing payment for teaching, research, or other services required as a condition for receiving the award. However, any part of a scholarship or fellowship that represents payment for teaching, research, or other services does not have to be included in income if the following conditions are satisfied.[118]

- The award was received under:
  - The National Health Service Corps Scholarship Program (NHSC Scholarship Program), or
  - The Armed Forces Health Professions Scholarship and Financial Assistance Program (Armed Forces Scholarship Program).
- The student is a degree candidate at an eligible educational institution.
- That part of the scholarship or fellowship is used to pay qualified education expenses.

Note. The exclusion from income for awards received under the NHSC Scholarship Program or the Armed Forces Scholarship Program was set to expire on December 31, 2010. However, recent legislation extended the exclusion through December 31, 2012.

Example 40. Christine, a degree candidate, received a scholarship of $2,500 from Gala University. As a condition of receiving the scholarship, Christine must serve as a part-time teaching assistant. Of the $2,500 scholarship, $1,000 represents payment for teaching. Gala University reports $1,000 as income on Form W-2.

Christine's tuition for the year was $3,000. The entire scholarship was used for tuition. $1,500 of the scholarship is excludable from income. The $1,000 Christine received for teaching is **not excludable** and must be included in income.

A scholarship or fellowship that is conditional upon past, present, or future services is considered payment for services.[119]

Example 41. Nathan, a degree candidate, receives a $10,000 scholarship from Killjoy Corporation in 2011. As a condition to receiving the scholarship, Nathan agrees to work for Killjoy after graduation. Nathan has no previous relationship with Killjoy. The $10,000 scholarship represents payment for future services and must be included as wages in computing Nathan's 2011 gross income.

118. IRC §§117(b) and (c).

119. Prop. Treas. Reg. §1.117-6(d)(2).

Example 42. Shannon, a degree candidate, receives a $3,000 scholarship from the Daily News. Shannon worked as a newspaper carrier for the Daily News for the last three years. The Daily News provides scholarships to all newspaper carriers who have delivered newspapers for at least three years. The $3,000 scholarship represents payment for past services and must be included in Shannon's gross income.

ATHLETIC SCHOLARSHIPS

An athletic scholarship can be excluded from income if:[120]

- The athlete is admitted to the educational institution under generally applicable admission standards;
- The athlete is a full-time student;
- The scholarship is awarded by the same agency that awards academic scholarships;
- The scholarship cannot be terminated due to injury or a unilateral decision not to participate in sports and the student is not required to engage in any activity in lieu of sports; and
- The value of the scholarship does not exceed expenses for tuition, fees, room, board, and necessary supplies.

REPORTING SCHOLARSHIPS AND FELLOWSHIPS

Whether a scholarship or fellowship must be reported on a tax return depends on whether the person receiving the award must file a return and whether any part of the award is taxable. It is not necessary to file a tax return if the individual's only income is a completely tax-free scholarship or fellowship. If all or part of the award is taxable and the individual is required to file a tax return, the taxable amount should be included on line 7 (wages and salaries) of Form 1040. **If the taxable amount was not reported on Form W-2, the taxable amount and the notation "SCH" should be entered in the space to the left of line 7.**

Note. The majority of scholarships and fellowships are not reported on Form W-2. However, the taxable portion of the award must still be reported on line 7 of Form 1040.

Any part of the award that is reported on Form 1099-MISC, *Miscellaneous Income,* as pay for teaching or other services is subject to SE tax.[121]

QUALIFIED TUITION REDUCTION

A tuition reduction allows an individual the opportunity to study without paying tuition or for a reduced rate of tuition. **Qualified tuition reductions do not have to be included in income.**

A tuition reduction is qualified only if it is received from, and used at, an eligible educational institution.[122] It is not necessary that an individual use the tuition reduction at the eligible educational institution from which it was received. Instead, a person may work for one eligible educational institution and make arrangements to take courses at another eligible educational institution without paying any tuition.

Example 43. Leon is an academic professional employed at the University of Illinois. His son, Reggie, wants to attend Southern Illinois University. Leon applies for a 50% tuition waiver for Reggie. If Leon and Reggie meet all the eligibility requirements, the waiver may be used to reduce Reggie's tuition costs at SIU.

The rules for determining if a tuition reduction is qualified, and thus tax-free, are different depending on whether the education provided is below the graduate level or at the graduate level.

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120. Rev. Rul. 77-263.

121. IRS Pub. 970, *Tax Benefits for Education*.

122. The definition of **eligible educational institution** is the same as that described earlier in the "Taxation of Scholarships and Fellowships" section.

Education below the Graduate Level

If a person receives a tuition reduction for education below the graduate level (including primary and secondary school), it is a qualified tuition reduction only if the student's relationship to the educational institution providing the benefit is described below.

1. The individual is an employee of the eligible educational institution.
2. The individual was an employee of the eligible educational institution but retired or left on disability.
3. The individual is a widow(er) of an individual who died while an employee of the eligible educational institution or who retired or left on disability.
4. The individual is the dependent child or spouse of an individual described in 1–3 above.

Graduate Education

A tuition reduction for graduate-level education is qualified if **both** of the following requirements are met.

- It is provided by an eligible educational institution.
- The individual receiving the tuition reduction is a graduate student who performs teaching or research activities for the educational institution.

REPORTING A TUITION REDUCTION

A taxable tuition reduction should be included as wages in box 1 of Form W-2. This amount should then be reported on line 7 of Form 1040.

Example 44. Kevin is a full-time employee at State University. Kevin applies for a tuition reduction for the education of his son, Keith, who has been accepted into State University as an undergraduate student. Keith is not Kevin's dependent. If the tuition reduction is granted by State University, the amount of the reduction is taxable to Kevin and should be included as wages on his Form W-2.

OTHER TYPES OF EDUCATIONAL ASSISTANCE[123]

There are various types of educational assistance available other than scholarships, fellowships, and tuition reductions. Some of the more common types of assistance are discussed below.

PELL GRANTS

Pell grants are based on need and are treated as scholarships for federal tax purposes. They are nontaxable to the extent used for qualified educational expenses during the period for which a grant is awarded. Only the taxable amount, if any, should be reported on the recipient's tax return.

FULBRIGHT GRANTS

A Fulbright grant is generally treated as a scholarship or fellowship in calculating how much of the grant is nontaxable. Only the taxable amount should be reported on the recipient's tax return.

VETERANS' BENEFITS

Payments received for education, training, or subsistence under any law administered by the Department of Veterans Affairs (VA) are nontaxable. These payments should **not** be included as income on the recipient's federal tax return.

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123. IRS Pub. 970, *Tax Benefits for Education*.

If the recipient of VA benefits qualifies for one or more additional educational benefits, they may have to reduce the amount of education expenses qualifying for a specific benefit by part or all of the VA payments.

Example 45. Sol Sailor returned to college and is receiving benefits under the GI Bill. He receives a $1,600 monthly basic allowance for housing (BAH) that is deposited directly into his checking account, and $4,000 is paid directly to his college for tuition. Neither of these benefits is taxable to Sol, and he does not report them on his tax return.

Sol also wants to claim an AOC on his return. He paid $5,000 in qualified education expenses. To figure the amount of his credit, Sol must first subtract the $4,000 from his qualified education expenses because that amount was paid directly to the college under the GI Bill. Sol does not subtract any part of the BAH because it was paid to him and its use was not restricted.

BUSINESS-RELATED EDUCATION EXPENSES

Certain college expenses may be deductible as business-related education expenses under IRC §162. The business expense deduction has three basic elements:

1. The taxpayer must be carrying on a trade or business,
2. The expense must be directly connected with the trade or business, and
3. The expense must be ordinary and necessary.

Observation. There are inconsistencies between case law and IRS publications. According to IRS Pub. 970, business-related education obtained during a temporary absence from work is deductible if it otherwise meets the deduction requirements. Business-related education obtained during an **indefinite absence** from work is **not** deductible, even if it otherwise meets the deduction requirements. The IRS considers an absence of one year or less to be temporary. The Tax Court, however, typically uses a facts and circumstances test. If the taxpayer is considered as carrying on an existing trade or business during the absence, then the education expenses are deductible if they otherwise meet the deduction requirements.[124]

IRS regulations specifically prohibit deducting the following expenses for business-related education.

- Expenses qualifying the taxpayer for a new trade or business[125]
- Expenses necessary to meet the minimum requirements for the taxpayer's job[126]

Example 46. Katherine is an accountant. Her employer requires her to get a law degree at her own expense. Katherine registers at a law school for the regular curriculum that leads to a law degree. Even though the education is required by her employer and she does not intend to become a lawyer, the education expenses are not deductible because the law degree qualifies Katherine for a new trade or business.

Observation. Bar examination or CPA examination review courses are not deductible as business-related education. They are considered expenses qualifying the taxpayer for a new trade or business.

124. See, for example, *Furner v. Comm'r,* 393 F.2d 292 (7th Cir. 1968).

125. Treas. Reg. §1.162-5(b)(3).

126. Treas. Reg. §1.162-5(b)(2).

QUALIFYING EXPENSES

To qualify as a deductible expense, business-related education must meet one of the following tests:

- The education is required (by an employer, by law, or by governmental regulation) for the taxpayer to continue to maintain their current salary, status, or job. Additionally the required education must serve a bona fide business purpose of the employer, or
- The education maintains or improves the taxpayer's current job skills.

Example 47. Cynthia, a general practitioner of medicine, takes a 2-week course reviewing new developments in several specialized fields of medicine. The education expenses are deductible because they maintain or improve Cynthia's job skills and do not qualify her for a new trade or business.

Deductible expenses include tuition, textbooks, lab fees, and supplies. Additionally, certain transportation and travel expenses may be deductible. Capital expenses are not deductible.

Qualified education expenses must be reduced by the following:

- Any tax-free benefits such as:
  - Tax-free scholarships and fellowships,
  - Pell grants,
  - Veterans' education assistance benefits, or
  - Qualified tuition reductions.
- The amount, if any, that is deducted under any other provision of the tax law such as expenses used to compute the following:
  - Hope/AOC or lifetime learning credits or tuition and fees deduction
  - Tax-free withdrawals from Coverdell ESAs
  - Tax-free withdrawals from §529 plans
  - Interest exclusion from U.S. savings bonds

Qualifying business-related education expenses are deductible even if the education could lead to a degree.

Example 48. Alison is a teacher who has satisfied the minimum requirements for teaching. Her employer requires Alison to take an additional college course each year to keep her teaching job. If the courses will not qualify Alison for a new trade or business, they are qualifying education even if Alison eventually receives a master's degree and an increase in salary because of this extra education.

LOCAL TRANSPORTATION EXPENSES

Because commuting costs are not deductible business expenses, expenses incurred in traveling between an individual's home and school are generally nondeductible. However, taxpayers whose education qualifies as a business-related expense **can deduct the local transportation costs of going directly from work to school.** Taxpayers who are regularly employed and go to school on a temporary basis **can also deduct the costs of returning from school to home.**[127]

[127] IRS Pub. 970, *Tax Benefits for Education*.

Education is considered to be on a **temporary basis** if either of the following situations applies.[128]

1. The taxpayer's attendance at school is expected to and does last one year or less.
2. The taxpayer's attendance at school is realistically expected to last one year or less but at a later date attendance is reasonably expected to last more than one year. In this situation, the attendance is temporary up to the date the taxpayer determines it will last more than one year.

If either of the above situations applies to the taxpayer, attendance is not considered temporary if facts and circumstances indicate otherwise.

Taxpayers who are regularly employed and go directly from home to school on a temporary basis can deduct the round-trip costs of transportation between their home and school. This applies regardless of the location of the school, the distance traveled, and whether or not school is attended on nonwork days.[129]

Example 49. Emma attends school two nights a week for three months to take a class to improve her job skills. Because the school attendance is temporary and Emma is regularly employed, she can deduct her transportation expenses incurred in traveling directly between work and school and then between school and home.

Example 50. Matt attends school two nights a week for two years to take classes that improve his job skills. Because the school attendance is **not** temporary, Matt can only deduct his transportation expenses between work and school.

Example 51. Robyn attends school for nine months on Saturdays, which are nonwork days. Because she is attending school on a temporary basis, Robyn can deduct her round-trip transportation expenses in going between home and school.

Transportation expenses include the actual costs of bus, subway, cab, or other fares, as well as the standard mileage rate plus parking and tolls for use of a personal automobile. Transportation expenses do not include amounts spent for travel, meals, or lodging while the taxpayer is away from home overnight.

TRAVEL EXPENSES

Expenses for travel, meals (subject to the 50% limitation), and lodging are deductible if:[130]

- The taxpayer traveled overnight to obtain qualified education, and
- The main purpose of the trip was to attend a work-related course or seminar.

If the main purpose of the trip is personal, then only the lodging and 50% of the expenses for meals incurred during the time the taxpayer attends the qualifying educational activities are deductible. Expenses incurred for personal activities, such as sightseeing or entertainment, are not deductible.[131]

Example 52. David works in Newark, New Jersey. He traveled to Chicago to attend a deductible week-long course at the request of his employer. His main reason for going to Chicago was to attend the course.

While there, he took a sightseeing trip and attended a Cubs game. Because the trip was mainly for business education, David can deduct his round-trip airfare and the meals (subject to the 50% limitation) and lodging connected with his educational activities. He cannot deduct the cost of the sightseeing trip or the tickets to the Cubs game.

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128. Ibid.

129. Ibid.

130. Treas. Reg. §1.162-5(e).

131. Treas. Reg. §1.162-5(e)(1).

Whether a trip's purpose is mainly personal or educational depends upon the facts and circumstances. An important factor is the comparison of time spent on personal activities with the time spent on educational activities.

Example 53. Molly works in Boston and must enroll in qualifying work-related education. She has several locales to choose from in completing the required course. She goes to a university in Illinois to take the course, and her reasons for taking it in Illinois are all personal.

Molly takes one course, which is one-fourth of a full course load at the university. She spends the rest of her time engaged in personal activities.

Molly's trip is mainly personal because three-fourths of her time is considered personal time. She cannot deduct the cost of her round-trip train ticket to Illinois. She can deduct one-fourth of her meals (subject to the 50% limit) and lodging costs for the time she attended the university.

Travel as a form of education is not deductible even if it is directly related to business.[132]

Example 54. Danielle is a French language teacher. While on sabbatical leave granted for travel, Danielle traveled through France to improve her knowledge of the French language. She chose her itinerary and most of her activities to improve her French language skills. Danielle **cannot** deduct her travel expenses as education expenses.

EMPLOYEE-PAID EXPENSES

If the taxpayer is an employee, the cost of qualifying work-related education can be deducted only if the taxpayer:

1. Did not receive any reimbursement from the employer,
2. Was reimbursed under a nonaccountable plan (i.e., the amount is included in box 1 of Form W-2), or
3. Received reimbursement under an accountable plan (i.e., the employer does not include any reimbursement in box 1 of Form W-2) but the amount received was less than the expenses incurred.

If item 1 or 2 applies, the taxpayer can deduct the total qualifying cost. If item 3 applies, the taxpayer can deduct only the qualifying costs that exceed the amount of the reimbursement.

The cost of the qualifying work-related education should be included on Schedule A of Form 1040 as a miscellaneous itemized deduction subject to the 2% of AGI limitation. Additionally, Form 2106, *Employee Business Expenses,* or Form 2106-EZ, *Unreimbursed Employee Business Expenses,* generally must be completed. Neither Form 2106 nor 2106-EZ is required if:

- Any reimbursements are included in box 1 of the taxpayer's Form W-2, and
- The taxpayer is not claiming travel, transportation, meal, or entertainment expenses.

132. IRC §274(m)(2).

Example 55. Russell Holmes teaches math at a private high school in Iowa. He was selected to attend a 3-week math seminar at a university in California. The seminar will improve his skills in his current job and is qualifying work-related education. Russell was reimbursed for his expenses under his employer's nonaccountable plan, so his reimbursement of $2,100 is included in the wages shown in box 1 of his Form W-2.

Russell's actual expenses for the seminar are as follows:

Lodging	$1,050
Meals	526
Airfare	550
Taxi fares	50
Tuition and books	400
Total expenses	$2,576

Russell files the following Form 2106-EZ with his tax return. He enters $1,650 ($1,050 + $550 + $50) on line 3 to account for his lodging, airfare, and taxi fares. He enters $400 on line 4 for his tuition and books. On line 5, Russell enters $526 for meal expenses and multiplies that amount by 50%. Russell carries the total from line 6 to Schedule A, line 21.

For Example 55

Form **2106-EZ**

Department of the Treasury Internal Revenue Service (99)

Unreimbursed Employee Business Expenses

▶ Attach to Form 1040 or Form 1040NR.

OMB No. 1545-0074

2011

Attachment Sequence No. **129A**

Your name	Occupation in which you incurred expenses	Social security number
Russell Holmes	Teaching	444 55 6666

You Can Use This Form Only if All of the Following Apply.

- You are an employee deducting ordinary and necessary expenses attributable to your job. An ordinary expense is one that is common and accepted in your field of trade, business, or profession. A necessary expense is one that is helpful and appropriate for your business. An expense does not have to be required to be considered necessary.
- You **do not** get reimbursed by your employer for any expenses (amounts your employer included in box 1 of your Form W-2 are not considered reimbursements for this purpose).
- If you are claiming vehicle expense, you are using the standard mileage rate for 2011.

Caution: *You can use the standard mileage rate for 2011* ***only if: (a)*** *you owned the vehicle and used the standard mileage rate for the first year you placed the vehicle in service,* ***or (b)*** *you leased the vehicle and used the standard mileage rate for the portion of the lease period after 1997.*

Part I **Figure Your Expenses**

1	Complete Part II. Multiply line 8a by 51¢ (.51) for miles driven **before** July 1, 2011, and by 55.5¢ (.555) for miles driven **after** June 30, 2011. Add the amounts , then enter the result here	1	
2	Parking fees, tolls, and transportation, including train, bus, etc., that **did not** involve overnight travel or commuting to and from work	2	
3	Travel expense while away from home overnight, including lodging, airplane, car rental, etc. **Do not** include meals and entertainment	3	1,650
4	Business expenses not included on lines 1 through 3. **Do not** include meals and entertainment	4	400
5	Meals and entertainment expenses: $ 526 × 50% (.50). (Employees subject to Department of Transportation (DOT) hours of service limits: Multiply meal expenses incurred while away from home on business by 80% (.80) instead of 50%. For details, see instructions.)	5	263
6	**Total expenses.** Add lines 1 through 5. Enter here and on **Schedule A (Form 1040), line 21** (or on **Schedule A (Form 1040NR), line 7**). (Armed Forces reservists, fee-basis state or local government officials, qualified performing artists, and individuals with disabilities: See the instructions for special rules on where to enter this amount.)	6	2,313

Part II **Information on Your Vehicle.** Complete this part **only** if you are claiming vehicle expense on line 1.

7 When did you place your vehicle in service for business use? (month, day, year) ▶ ____/____/____

8 Of the total number of miles you drove your vehicle during 2011, enter the number of miles you used your vehicle for:

a Business ________ b Commuting (see instructions) ________ c Other ________

9 Was your vehicle available for personal use during off-duty hours? ☐ Yes ☐ No

10 Do you (or your spouse) have another vehicle available for personal use? ☐ Yes ☐ No

11a Do you have evidence to support your deduction? ☐ Yes ☐ No

b If "Yes," is the evidence written? ☐ Yes ☐ No

For Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 20604Q Form **2106-EZ** (2011)

BUSINESS-PAID EXPENSES

If the taxpayer is self-employed, work-related education must qualify as a business expense deduction under IRC §162 to be deductible. This deduction is claimed on Schedule C, *Profit or Loss from Business (Sole Proprietorship),* or Schedule F, *Profit or Loss From Farming*.

Qualified expenses paid by a business for employees are deductible as an ordinary and necessary business expense by the business. Those expenses are not considered income to the employee. They are treated as a working condition fringe benefit.

INTERACTION WITH OTHER EDUCATION TAX INCENTIVES

Expenses deducted as business-related education cannot be used as the basis for any other tax deduction or tax credit. When an expense is deductible under more than one tax law provision, the taxpayer can choose where to claim the expense. The total expense can be divided between several different provisions.

Observation. When an expense is deductible under more than one tax law provision, the practitioner usually needs to calculate the return several different ways in order to obtain the lowest tax liability. Some tax software programs will calculate the tax using the various available options in order to ensure optimal results.

Example 56. Ryan has $3,000 of business-related education expenses. Ryan's other miscellaneous itemized deductions exceed 2% of his AGI. This means Ryan is obtaining a tax benefit for the entire $3,000 of education expenses.

Suppose $2,000 of those business-related education expenses also qualify for the tuition and fees deduction. Ryan would have a lower tax liability by claiming $2,000 as a tuition and fees deduction and $1,000 as an itemized deduction. The tuition and fees deduction reduces his AGI, which increases the deductible amount of his miscellaneous itemized deductions.