

COLLEGE FUNDING, INC.

Education Tax Incentives

and

Financial Aid Consequences



By

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EDUCATION TAX INCENTIVES AND FINANCIAL AID CONSEQUENCES

The August 22, 1997 issue of "The Kiplinger Tax Letter" contained the following paragraph:

"There's a key non-tax aspect of college funding to keep in mind: The financial aid maze. Assets in a child's name for tax reasons may boomerang when financial aid rules are applied. Yet those rules seem to change as often as the tax rules, making early planning chancy at best."

This excerpt illustrates the obligation that a financial professional has to understand the correlation between the new education tax laws and the financial aid laws. Financial professionals cannot afford to ignore the effects which tax strategies may have on the financial aid eligibility of the client's children.

A synopsis of the financial aid system should be reviewed before the interrelationship between the new education tax laws and financial aid laws is discussed. A critique of the potential financial aid ramifications resulting from the new education laws ensues.

HOPE SCHOLARSHIP CREDIT (HC)

The HC is a non-refundable credit against an individual's federal income tax liability.

EFFECTIVE DATE The HC is available for qualified education expenses paid after December 31, 1997 for academic periods beginning after that date.

CALCULATION OF CREDIT The HC is calculated by taking 100% of the first \$1,200 of "qualified tuition and related expenses" plus 50% of the excess of these expenses up to a \$1,200 limit. For example, if the qualified expense of an individual student were \$2,400, the HC would be \$1,800 (100% x \$1,200 plus 50% x \$1,200). If the expenses were only \$1,600, the HC would be \$1,400 (100% x \$1,200 plus 50% x \$400).

MAXIMUM CREDIT ALLOWED The maximum HC allowed per student is \$1,800 per year. The credit can be claimed for each student claimed on the tax return. For example, if there are two "eligible students" that have qualified expenses, a maximum HC of \$3,600 (2 students x \$1,800) can be claimed.

CREDIT PHASE OUT The HC is phased out when the taxpayer reaches certain levels of "Modified Adjusted Gross Income." The credit is ratably phased out for Modified AGI of between \$48,000 to \$58,000 for single or head of household taxpayers, and between \$96,000 to \$116,000 for married taxpayers. For example, a married taxpayer, with \$106,000 in Modified AGI, would have a maximum HC of \$900 per eligible student. Modified AGI is AGI plus foreign income, or certain types of income from Puerto Rico, Guam, American Samoa, or the Northern Mariana Islands. The prior types of excluded income are defined in IRC Sections 911, 931, or 933.

As a tax planning strategy, parents that have Modified AGI in excess of the phase out levels (Single-\$58,000, or Married-\$116,000) may either not claim the student on their tax return or want to have the student meet the criteria for claiming himself as a tax exemption. If the student then pays the qualified education expenses, he can claim the HC, provided the student's Modified AGI is not above the phase out limits. Nonetheless, by not being claimed on his parents' tax return, a student does not make himself "independent" of his parents under the financial aid rules. The parents' income and assets will still have to be listed on the student's financial aid application; this tax planning strategy will not increase the student's financial aid eligibility. Furthermore, if the student is showing that he is providing over half of his support, this tax strategy may actually drastically reduce the student's financial aid eligibility.

In the scenario where two members of the family are attending college at the same time, the described tax strategy, having one student claim himself as an exemption, may produce a loss of total financial aid for the family that far outweighs the tax benefits. The family would go from having two students in college to only one and would not be allowed to list the student who claimed himself on his tax return as a member of the family. To be considered a member of the family under the financial aid regulations, the parents must provide more than half the support of the family member.

QUALIFIED EXPENSES The HC is only available for certain qualified expenses for undergraduate courses at "eligible educational institutions." Qualified expenses are tuition and related fees at these eligible educational institutions, and do not include books, room and board, personal transportation or living expenses, activity fees, or insurance. The qualified expenses have to actually be paid during the academic period or within three months after the beginning of the academic period. For example, a

taxpayer that pays qualified expenses, during calendar year 2007 for an academic period that begins in January, February, or March of 2008, will qualify for the HC in 2007. Qualified expenses paid with the proceeds of a loan would be eligible for the HC.

By prepaying or delaying the payment of qualified expenses the taxpayer may effectively choose the year in which he claims the HC. Also, the taxpayer can use this type of planning to insure that the maximum HC of \$1,800 per year is reached for the two years that the student qualifies for the credit. For example, if a student is not going to have enough qualified expenses in 2008, he may choose to prepay some of the 2009 tuition prior to January 1, 2009 in order to receive the maximum HC in 2008.

The qualified expenses are reduced by tax-free grants or scholarships (IRC Sec. 117), employer provided educational assistance (IRC Sec. 127), veteran's education benefits (IRC Sec. 134), and qualified expenses deducted elsewhere on the tax return (e.g., Schedule A, C, or F.). When considering the above reductions of eligible expenses, there may be little or no expenses which qualify for the HC. Many families with an annual income of \$35,000 or less qualify for enough Federal Pell Grants and other tax-free scholarships or grants, to disqualify themselves for HC, regardless of whether the student attends a two-year or four-year public, or a four-year private college.

Only out-of-pocket qualified expenses are used to calculate the HC. The expenses may be paid by the student or the parents of the student for the student (if claimed as a dependent on the parent's tax return). The expenses can be paid, with no reduction in qualified expenses, by loans (loan repayments for qualified expenses do not count as qualified expenses), savings (including savings from a qualified tuition program), gifts, bequests, devises, or inheritances.

However, the family must be aware of the consequences of gifting. For example, a student receives a \$12,000 cash gift for Christmas from his grandparents with the stipulation that the student put the gift in a savings account for the upcoming-year's college expenses. The financial aid formula will consider the cash gift as financial aid income and assess it at a flat 50% and thereby lower the student's financial aid eligibility by \$6,000. The financial aid formula will also assess the student's savings account at a flat 20% and thus lower the student's financial aid eligibility by an additional \$2,400. Therefore, the student can potentially have his financial aid eligibility reduced by a combined 70% ($\$6,000 + \$2,400 = \$8,400$) of the value of the cash gift.

In this given situation, the grandparents could decide to make the gift directly to the college for the tuition of the student. Should the grandparents implement this strategy, their annual gift exclusion will not be reduced and they avoid the 70% potential loss in financial aid eligibility as occurred above. Unbelievably, the financial aid consequences of this strategy could be even worse than before: The payment made directly to the college is considered a "resource" of the student and reduces financial aid eligibility on a dollar-for-dollar basis.

As an example, a student attends a college whose COA is \$22,000 and tuition is \$14,000. The "Expected Family Contribution," EFC, is \$8,000 and the student's "Financial Need" is computed to be \$14,000. (COA, \$22,000, minus EFC, \$8,000 equals Financial Need, \$14,000.) When the college receives the \$12,000 gift directly from the grandparents, it will reduce the Financial Need of the student to \$2,000. (Financial Need, \$14,000, minus Resource, \$12,000, equals Adjusted Financial Need, \$2,000). Now the grandchild would be eligible to receive only \$2,000 in financial aid rather than the \$14,000 he was originally eligible to receive.

ELIGIBLE STUDENTS To be eligible for the HC, the student must not have completed (before the beginning of such taxable year) the first two years at an eligible educational institution. The student must be the taxpayer, the taxpayer's spouse, or a dependent of the taxpayer. Since the student must be a dependent of the taxpayer, a single custodial parent must both claim the student as a dependent on the tax return and also pay the qualified expenses of the student. Beware of situations where either the student is not claimed on the tax return or the qualified expenses are not paid by the parent claiming the dependency exemption. In this situation the HC may not be claimed by either the parent claiming the student as a dependent or by the parent paying the qualified expenses of the student (e.g., divorce or separation situations).

Also, the student must be enrolled in a degree, certificate, or other program leading to a recognized educational credential at an eligible educational institution; this includes an approved program of study abroad. The student must be enrolled on at least a half-time basis. Half-time enrolment is defined as at least one academic period, which begins during the taxable year during which the student must carry at least one-half the normal full-time workload for the course of study the student is pursuing; usually six credits. This is the same definition that is used (under the Higher Education Act regulations) to determine the "number in the household who will be attending college." There can be a great financial aid benefit for having several members of the household in college at the same time.

Married taxpayers must file a joint tax return to be eligible for the HC.

The student must not have been convicted of a federal or state drug felony offense consisting of the possession or distribution of a controlled substance.

A nonresident alien may not claim the HC. There is an exception for certain nonresident aliens who are married to U.S. citizens or resident aliens.

The student must have a high school diploma or its equivalent.

ELIGIBLE EDUCATIONAL INSTITUTIONS To qualify for the HC the student must be attending an eligible educational institution. The institution must be a post-secondary institution, not a high school institution. The institution must meet the criteria defined in section 481 of the 1965 Higher Education Act and, therefore qualify to participate in the student aid programs administered by the Department of Education. This would include virtually all accredited public, nonprofit, and proprietary postsecondary institutions.

INTERACTION WITH OTHER EDUCATION TAX BENEFITS The HC cannot be claimed for the same qualified expenses for which the Lifetime Learning Credit, LC, is claimed.

The HC can be claimed in the same year as the student receives a distribution from a "qualified tuition program."

FINANCIAL AID CONSEQUENCES At colleges that require the PROFILE to be filed, the HC amount claimed on the tax return will reduce the student's financial aid eligibility by as much as 46%, the parents' financial aid income assessment rate, of the HC claimed. For example, if the parents claim a \$1,800 HC on their tax return, it could reduce the student's financial aid eligibility by \$828 ($\$1,800 \times 46\%$).

LIFETIME LEARNING CREDIT (LC)

The LC is a non-refundable credit against the individual's federal income tax liability.

EFFECTIVE DATE The LC is available for qualified education expenses paid after June 30, 1998, for academic periods beginning after that date.

CALCULATION OF CREDIT The LC is calculated by taking 20% of up to a maximum of \$10,000 in "qualified tuition and related expenses"; the limit for the LC is \$2,000 per taxpayer tax return. For example, if a family has a combined total of \$12,000 in qualified expenses for all the exemptions claimed on the tax return, the LC for the tax return would be \$2,000, 20% x \$10,000 maximum qualified expenses. If the same family only had combined expenses of \$8,000, the LC would be \$1,600, 20% x \$8,000.

MAXIMUM CREDIT ALLOWED The maximum LC allowed per taxpayer return is \$2,000 per year and the credit cannot be claimed for multiple students on the same tax return. For example, if there are two "eligible" students that each have qualified expenses of \$10,000, the maximum LC that could be claimed is \$2,000 per that taxpayer return.

CREDIT PHASE OUT The LC is phased out when the taxpayer reaches certain levels of Modified AGI. (Modified AGI is the same as it is for purposes of the HC.) The credit is ratably phased out under the same rules as the HC. For example, a married taxpayer with \$106,000 Modified AGI, would have a maximum LC of \$1,000 per taxpayer return.

As a tax planning strategy, families which have a Modified AGI in excess of the phase out levels (Single or Head of Household, \$58,000; or Married, \$116,000) may want to have the student meet the criteria for claiming himself as a tax exemption. If the student then pays the qualified education expenses, he can claim the LC, provided the student's Modified AGI is not above the phase out limits.

Another tax planning strategy to consider, for families with two students in college at the same time, is to either have one of the students meet the criteria for claiming himself as a tax exemption or the parents can elect to give up the exemption. If this student then pays the qualified education expenses, he can claim the LC for his expenses on his tax return, provided the student's Modified AGI is not above the phase out limits. In addition, the other student's qualified expenses could be claimed for the LC on the parent's tax return, provided the parents' Modified AGI is not above the phase out limits. The overall result of this strategy would be that two LCs, instead of only one LC, could be claimed by this family on the two separate taxpayer returns. However, be aware of the financial aid consequences of reducing the number of family members enrolled in college from two to one.

QUALIFIED EXPENSES The LC is available for certain qualified expenses for undergraduate, graduate, or professional degree courses at "eligible educational institutions." Qualified expenses for the LC have the same definition as the "qualified tuition and related expenses" for the HC. The HC and LC differ in the effective date for which these qualified expenses are incurred. The strategies for prepaying or delaying the payment of expenses, the reduction of qualified expenses by certain items, the effect on financial aid, the discussion of out-of-pocket expenses and the consequences of gifting, are the same for the LC as those for the HC.

ELIGIBLE STUDENTS There is no limit to the years in which an eligible student may claim the LC. The student must be the taxpayer, the taxpayer's spouse, or a dependent

of the taxpayer. The definition of an eligible student for the LC is the same as the HC, with three exceptions: (1) The student may be enrolled less than half-time and still qualify for the LC, (2) The courses, at eligible educational institutions, taken by the student may additionally be to acquire or improve job skills, and (3) The student convicted of a federal or state drug felony can qualify for the LC.

Even though the student may be enrolled on less than half-time basis, it may be a benefit, financial aid-wise, to take enough courses to be considered a “student enrolled half-time in college.”

ELIGIBLE EDUCATIONAL INSTITUTIONS The requirements to be considered an “eligible educational institution” for the LC are the same as those for the HC.

INTERACTION WITH OTHER EDUCATION TAX BENEFITS The LC cannot be claimed for the same qualified expenses for which the HC is claimed.

The LC can be claimed in the same year as a distribution from a “qualified tuition plan” is received by the student.

The LC can be claimed for some students at the same time that the HC is claimed for other students in the family. For example, if a family has a student in his first year of college and a student in his third year in college, the HC may be claimed for the expenses of the student in his first year of college and the LC may be claimed for expenses of the student in his third year of college.

FINANCIAL AID CONSEQUENCES At colleges that require the PROFILE form to be filed, the LC amount claimed on the tax return will reduce the student’s financial aid eligibility by as much as 46%, the parents’ income assessment rate, of the LC claimed. For example, if the parents claimed a \$2,000 LC on their tax return, it could reduce the student’s financial aid eligibility by \$920 ($\$2,000 \times 46\%$).

COVERDELL EDUCATION SAVINGS ACCOUNT (CESA)

The Coverdell Education Savings Account (CESA), formerly the Education IRA, is a trust account funded by non-deductible contributions. The CESA is used to pay for future qualified education expenses of the beneficiary (student) of the account. The CESA is exempt from income tax except for tax on unrelated business income.

EFFECTIVE DATE CESAs can be established and contributed to after December 31, 1997.

CALCULATION OF THE CONTRIBUTION The maximum contribution to a CESA is \$2,000 per year per beneficiary. The contribution must be made in cash and no contributions can be made after the beneficiary reaches 18 years of age.

Aggregate contributions for the benefit of a particular beneficiary in excess of \$2,000 for a calendar year are treated as excess contributions. If the excess contributions (and any earnings attributable to them) are not withdrawn from the CESA before the before the 1st day of the sixth month of the tax year following the year in which the contributions are made, the excess contributions are subject to a 6% excise tax for each year the excess amount remains in the account.

MAXIMUM LIFETIME CONTRIBUTION ALLOWED The maximum lifetime contribution that can be made for a beneficiary is \$36,000 (\$2,000 x 18 years). Contributions to a CESA must be made before due dates of a contributor's tax return (usually April 15th).

CONTRIBUTION PHASE OUT Contributions to a CESA are phase out when the taxpayer reaches certain levels of Modified AGI. Modified AGI has the same definition as used for the HC and the LC. The contribution is ratably phased out for Modified AGI of between \$95,000 and \$110,000 for single or head of household taxpayers, and between \$190,000 and \$220,000 for married taxpayers. For example, a married taxpayer with Modified AGI of \$205,000 could contribute a maximum of \$1,000 to a CESA. Nonetheless, the beneficiary of the CESA could have other contributions to the account that total \$2,000 for that year.

As a planning strategy, a taxpayer that had Modified AGI in excess of the phase out limits could gift the cash to another taxpayer (possibly the beneficiary of the CESA), with Modified AGI less than the phase out limits. This taxpayer could then make the maximum contribution of \$2,000.

DISTRIBUTION FOR QUALIFIED EXPENSES If distributions from the CESA are made for qualified education expenses, the distributions are tax-free. Qualified education expenses are the "Cost of Attendance" expenses, as defined by Section 472 of the Higher Education Act of 1965, at a qualified post-secondary institution. The cost of attendance consists of tuition, fees, books, supplies, equipment, room and board, only when the student is enrolled on at least a half-time basis. Qualified expenses now include K-12 private school expenses as well. If the distribution is in excess of the qualified expenses for a particular calendar year, the excess distribution will be taxable. The taxable portion is the portion that represents earnings that have accumulated tax-free in the CESA. The taxable portion of the distribution is also subject to a 10% penalty. The penalty is waived if the beneficiary dies, is disabled, or receives a grant or scholarship that causes the qualified expenses to be less than the CESA distribution.

If CESA distributions are taxable, because the distribution does not meet the criteria for

tax-free status, they are taxed similar to annuity rules. Part of the distribution consists of principle, which is not taxable, and part of the distribution consists of accumulated earnings, which are taxable.

ELIGIBLE STUDENTS To be eligible for a tax-free distribution from a CESA, the student can be enrolled on a less than half-time basis at a qualified post-secondary educational institution.

The student may have been convicted of a federal or state drug felony and still be an eligible student.

ELIGIBLE EDUCATIONAL INSTITUTIONS To qualify for a tax-free distribution from a CESA, the student must be enrolled at an “eligible educational institution.” The eligibility requirements for institutions are the same as those requirements used for the HC and the LC.

INTERACTION WITH OTHER EDUCATION TAX BENEFITS A tax-free distribution from a CESA can be made in the same year that a HC or LC is claimed for qualified education expenses. The CESA distributions, however, cannot be used for the same educational expenses.

A contribution to a CESA can be in the same year that a contribution is made to a “qualified tuition program.”

CESA TERMINATION The balance of a CESA must be distributed when the beneficiary becomes 30 years of age. If a CESA is terminated, without distributing all the funds in the account, the balance in the account will be subject to taxation and a 10% penalty. These tax consequences may be avoided if the account balance is “rolled over” to certain members of the designated beneficiary’s family. These family members include sons, daughters, brothers, sisters, nephews, nieces, certain in-laws, and any spouse of such persons. Should the beneficiary die, the CESA funds will be distributed to the beneficiary’s estate.

CESA GIFT TAX CONSIDERATIONS Contributions to a CESA are considered gifts and thus, will reduce the annual \$12,000 gift exclusion of the contributor.

FINANCIAL AID CONSEQUENCES Non-taxable distributions from a CESA during college years will not create financial aid income. If the student does not withdraw the CESA funds during college years, the value of the account will be assessed at the parent’s rate under the Federal and Institutional Methodologies. In addition, if the student’s siblings have CESAs and the student is required to file the PROFILE application form, the value of the siblings’ CESAs is assessed at the parents’ rate.

QUALIFIED TUITION PROGRAMS (QTP)

This is an investment program established and maintained by a state under which a person may: (1) prepay future tuition expenses on behalf of a beneficiary so that the beneficiary is entitled to a waiver or a payment of qualified post-secondary education expenses, (2) contribute to an account that is established for paying qualified higher education expenses of the beneficiary. The earnings attributable to prepayments or contributions is deferred and tax-free to the beneficiary/student when distributions are taken for qualified educational expenses.

EFFECTIVE DATE The changes to the existing tax provisions, regarding QTPs, are effective after December 31, 2001.

CALCULATION OF CONTRIBUTION A non-deductible contribution to a QTP may be made for qualified education expenses. The amount of the contribution is the amount put into the QTP.

MAXIMUM CONTRIBUTION ALLOWED The maximum contribution allowed is determined by the total qualified education expenses. Each individual state determines what this total amount will be for the QTP.

CONTRIBUTION PHASE OUT There is no phase out of the amount of contribution to a QTP due to taxpayer income levels.

QUALIFIED EXPENSES Contributions to a QTP may be made only for future qualified education expenses. Qualified higher education expenses may include tuition, fees, books, supplies, equipment, and room and board. The inclusion of room and board is limited to students who are enrolled on a half-time basis.

ELIGIBLE STUDENTS To qualify for a distribution from a QTP the beneficiary can be enrolled on a less than half-time basis. However, if a distribution for room and board is made from a QTP, then he must be enrolled on a half-time basis.

Members of a family eligible for this program include parents and stepparents, sons, daughters, brothers, sisters, nephews, cousins, and nieces, as well as the spouses of such persons.

The student may have been convicted of a federal or state drug felony.

ELIGIBLE EDUCATIONAL INSTITUTIONS To qualify to make a contribution to a QTP the student must be attending an "eligible educational institution." The definition of an "eligible educational institution" is the same definition as the definition used for the HC and the LC.

INTERACTION WITH OTHER EDUCATION TAX BENEFITS A contribution to a QTP will not affect eligibility for the HC or LC.

QTP GIFT CONSIDERATIONS Contributions to a QTP are considered completed gifts from the contributor to the beneficiary. Contributions that exceed the annual gift tax exclusion limit (currently \$12,000 for single parents and \$24,000 for married parents who gift split) may be treated as being made ratably over the 5-year period beginning in the year the contribution is made. For example, a contribution of \$40,000 made to a QTP could be treated as being made over 5 years and, thereby, an \$8,000 per year gift would be deemed to have been made by the contributor. The \$8,000 gift is less than the annual gift exclusion of \$12,000. Therefore, there would be no gift tax consequences to

the contributor. In the event of a rollover of the QTP funds, there are no transfer tax consequences if the beneficiaries are of the same generation. If the beneficiaries are of different generations, a 5-year averaging rule may be applied to exempt up to \$60,000 per contributor (\$120,000 for a married couple) of the transfer from gift tax.

The effective date of this gift tax provision is August 5, 1997. Contributions made prior to August 5, 1997 were not treated as complete gifts.

FINANCIAL AID CONSEQUENCES QTPs are treated as an asset of the parent if the student or parent is the account owner. If someone other than the student or parent owns the account, it is not included as an asset. An increasing number of colleges are considering the total distribution from a QTP to be a “resource” of the student which will reduce the student’s financial aid eligibility dollar-for-dollar. This is especially true when someone other than the student or parent owns the account,

A 1099-Q will be used to report distributions. Gross distributions will be reported along with the earnings portion and the portion representing basis. The recipient will have to figure out if it is taxable or exempt. Non-taxable distributions will not create financial aid income for the student.

STUDENT LOAN INTEREST DEDUCTION

A deduction to adjusted gross income is allowed for interest paid on qualified student loans. The loans do not have to be federal interest subsidized loans.

EFFECTIVE DATE The interest deduction is available for qualified loans due and paid after December 31, 1997.

CALCULATION OF THE INTEREST DEDUCTION The interest deduction is calculated by taking 100% of any interest due and paid on a qualified student loan.

MAXIMUM INTEREST DEDUCTION ALLOWED The maximum interest deduction allowed is \$2,500.

If a taxpayer wanted to delay the start of a Federal PLUS loan repayment period, he could enroll in college half-time or may be able to work with the lender to make payments once the student leaves school. (PLUS loans have favorable terms and are taken out by parents to pay the college costs not covered by financial aid.)

NOTE: Parents will be able to deduct interest expense on PLUS loans during college years. Repayment begins immediately after the loan proceeds are disbursed to the parents.

Students who claim themselves on their tax returns will be able to deduct interest expense on Federal Stafford and Perkins loans. Repayment of these loans does not begin until after the student leaves college.

INTEREST DEDUCTION PHASE OUT The deduction for student loan interest is phased out when the taxpayer reaches certain levels of Modified AGI. Modified AGI includes: (1) amounts excluded under IRC Sections 911, 931, and 933 (income earned abroad or from Puerto Rico or U.S. possessions), (2) amounts excluded from gross income under IRC Section 135, Series EE bonds used to pay higher education tuition and fees, and (3) amounts excluded under IRC Section 137, qualified adoption expenses. In addition, Modified AGI is calculated after application of IRC Section 219, deductible IRA provisions, and IRC Section 469, limitations on passive activity losses and credits. The deduction is ratably phased out for Modified AGI of between \$55,000 to \$70,000 for single and head of household taxpayers, and from \$115,000 to \$145,000 for married taxpayers.

As a tax planning strategy, families that have Modified AGI in excess of the phase out levels and do not qualify for financial aid, may have the student take out "Unsubsidized Federal Stafford Loans" during college years. The student can take out these loans even though he does not qualify for financial aid. The interest on these loans can be accrued and paid after the student leaves college. At that time the student will be able to file a tax return and claim an exemption for himself and will probably be under the income phase out levels. He can then deduct the interest on his tax return.

QUALIFIED EXPENSES The student loan interest deduction is only available for certain qualified expenses for undergraduate or graduate courses. The loan must have been used to pay the costs of attendance at an eligible educational institution for a student enrolled at least half-time in a program leading to a degree, certificate, or other recognized educational credential. These qualified educational expenses are defined in Section 472 of the Higher Education Act of 1965. These expenses include tuition, fees, room and board, supplies, equipment, transportation, and related personal expenses. Qualified expenses for the interest deduction include more items than are allowed for the

HC or LC.

The qualified expenses are reduced by: (1) IRC Section 135 exclusions, U.S. EE Savings Bonds used to pay education expenses, (2) distributions from CESAs which are excluded from gross income, (3) IRC Section 117 exclusions, scholarships or fellowship grants, and other tax-free educational assistance, such as IRC Section 127, employer provided education assistance.

ELIGIBLE STUDENTS To be eligible for the interest deduction, the student must have been enrolled on at least a half-time basis in a program leading to a degree, certificate, or other recognized educational credential. The student must be the taxpayer, the taxpayer's spouse, or a dependent of the taxpayer. No deduction is allowed for an individual who is claimed as a dependent on another taxpayer's tax return.

ELIGIBLE EDUCATIONAL INSTITUTIONS To qualify for the interest deduction, the student must have attended an eligible educational institution. The institution must be a post-secondary institution as defined in Section 481 of the Higher Education Act of 1965 and, therefore, eligible to participate in the federal student aid programs administered by the Department of Education. This category includes virtually all accredited public, nonprofit, and proprietary post-secondary institutions. For purposes of the student loan interest deduction, eligible educational institutions also include institutions that conduct an internship or residency program leading to a degree or certificate awarded by an institution of higher education, a hospital, or a health care facility that offers postgraduate training.

INTERACTION WITH OTHER EDUCATION TAX BENEFITS The qualified education expenses for the interest deduction are reduced by distributions from CESAs which are excluded from taxable income.

FINANCIAL AID CONSEQUENCES Since the interest deduction is toward AGI, this will increase the financial aid eligibility of any student who is currently enrolled in college. Since the interest deduction lowers the financial aid income of the parents or student, it could increase the financial aid eligibility by the amount of the interest deduction times the parents' (47%) or student's (50%) financial aid income assessment rate.

Some taxpayers may want to take out an equity loan on their personal residence and use the proceeds to pay for qualified education expenses. However, the interest expense on this equity loan must be deducted on Schedule A instead of toward AGI. If the student will be attending a college that does not assess the personal residence, it probably is more beneficial for the taxpayer to take out a PLUS loan, rather than a personal residence equity loan, in order to pay for the college costs. The interest would be deductible to AGI (subject to the maximum deduction limits) rather than as an itemized deduction, which may be of no benefit if the taxpayer uses the standard deduction.

Conversely, should the student be attending a college that will assess the personal residence equity, it may be advantageous for the parents to take out an equity loan on the personal residence, rather than a PLUS loan. The equity loan will reduce the value of the personal residence and therefore, increase the student's financial aid eligibility by the amount of the decrease in residence equity times the parent asset assessment rate of 5.6%.

For example, a home equity loan of \$12,000 will lower the value of the personal residence by that amount. Since the assessment rate for parents' assets is 5.6%, the student would be eligible for an increase in financial aid of \$672 per year, ($\$12,000 \times$

5.6%) annually.

As a financial planning strategy, the parents may elect, under Reg. 1.163 – 10T (o)(5), to treat any debt that is secured by a qualified residence as not so secured. The election is effective for the tax year for which the election is made and for all later tax years unless revoked with IRS consent. This election would allow the taxpayer to deduct the interest on his personal residence as education interest and, in addition, reduce the value of an assessable asset (the personal residence). This is the best of both worlds: tax and financial aid.

NOTE: The above election could be made for personal residence interest to be treated as a business expense. In addition to the tax advantages (reduction of self-employment tax and receiving a 100% deduction in all situations), the business interest deduction will reduce the parents' AGI. In turn, the reduction of AGI will increase the financial aid eligibility of the student by 47% (the parent's assessment rate on income); the decrease in AGI being a result of the interest deduction taken on Schedule C or F.

PENALTY FREE IRA WITHDRAWALS

Penalty free withdrawals from regular IRAs can be made to pay for undergraduate or graduate qualified higher education expenses for the taxpayer, the taxpayer's spouse, or the child or grandchild of the taxpayer or taxpayer's spouse at an eligible educational institution. The taxpayer will owe federal income tax on the amount withdrawn, but will not be subject to the 10% early withdrawal penalty (imposed when amounts are withdrawn from an IRA before the taxpayer reaches the age 59½).

EFFECTIVE DATE The penalty free IRA distribution is available for distributions made after December 31, 1997, for academic periods beginning after such date.

QUALIFIED EXPENSES The penalty free IRA withdrawal is only available if the withdrawal is used to pay for qualified education expenses. Qualified education expenses include tuition, fees, books, supplies, and equipment. Room and board are also included if the student is enrolled on at least a half-time basis. These education expenses must be reduced by any IRC Section 117 tax-free scholarships or grants, IRC Section 135 qualified U.S. Series EE bond, veteran's education benefits, and other tax-free educational benefits.

ELIGIBLE STUDENTS To be eligible for the penalty free IRA distribution the student must be the taxpayer, the taxpayer's spouse, or any child or grandchild of the taxpayer or the taxpayer's spouse at an eligible educational institution.

ELIGIBLE EDUCATIONAL INSTITUTION To qualify for the penalty free IRA distribution the student must be attending an eligible educational institution. For the purposes of the penalty free IRA distribution, the definition of an eligible educational institution is the same as the definition used for the HC, LC, and CESA

INTERACTION WITH OTHER EDUCATION TAX BENEFITS Tax-free distributions from a CESA, qualified U.S. EE Savings Bond, Qualified Tuition Plan, or employer-provided educational assistance reduce the amount of qualified education expenses for the penalty free IRA distribution.

FINANCIAL AID CONSEQUENCES The withdrawals from IRAs used for qualified higher education expenses may be penalty free, however, the withdrawals do have some adverse financial aid ramifications. These IRA withdrawals are considered taxable income and will reduce the financial aid eligibility of the student by 47% (the parents' assessment rate for income) of the increase in AGI caused by the taxable IRA withdrawal.

If grandparents withdraw penalty-free funds from their IRA accounts and use the money to pay for their grandchild's qualified education expenses, they must be aware of the financial aid consequences to the grandchild. Remember, payments made directly to the college for tuition and fees will reduce a student's financial aid eligibility on a dollar-for-dollar basis.

EMPLOYER-PROVIDED EDUCATIONAL ASSISTANCE

The 2001 tax bill extended tax-free treatment to employer-provided educational assistance for undergraduate courses, and graduate courses, regardless of whether the course is job-related.

Employers can provide job-related educational assistance for graduate and professional courses as a tax-free fringe benefit under certain circumstances. Educational assistance would generally qualify as job-related if it maintains or improves skills required for the employee's current job or satisfies certain express employer-imposed conditions for continued employment.

EFFECTIVE DATE The courses must begin after taxable years beginning December 31, 2001.

MAXIMUM DEDUCTION ALLOWED Employers may provide up to \$5,250 per year in educational assistance to each employee on a tax-free basis to the employee.

QUALIFIED EXPENSES Qualified expenses are those incurred for the student's tuition, fees, books, supplies, and equipment. Expenses related to sports, games or hobbies do not qualify for this exclusion.

ELIGIBLE STUDENTS The employer-provided educational assistance fringe benefit is limited to no more than 5% of the total amount spent on the employer-paid educational assistance program for employees, their spouses, or their dependents that have more than 5% ownership in the business. Children of the employer must reach 21 years of age by year-end to receive the benefit.

INTERACTION WITH OTHER EDUCATION TAX BENEFITS The amount of the tax-free employer-provided educational assistance reduces the taxpayer's qualified expenses for calculating the HC or LC.

FINANCIAL AID CONSEQUENCES These tax-free benefits are considered a "resource" of the student (employee) and, thereby, will reduce his financial aid eligibility on a dollar-for-dollar basis.

U.S. SERIES EE BONDS TAX-FREE INTEREST

The interest for EE bond redemptions, used to pay for qualified education expenses, is tax-free.

EFFECTIVE DATE This provision is effective for U.S. EE Bonds purchased after December 31, 1989.

MAXIMUM TAX-FREE INTEREST ALLOWED If a taxpayer's redemption proceeds (interest and principal) exceed the qualified education expenses for that year, a ratable portion of the interest proceeds is taxable. For example, if a taxpayer redeems \$10,000 (\$5,000 interest and \$5,000 principal) and pays only \$6,000 in qualified expenses, \$3,000 of interest would be taxable ($\$6,000 \div \$10,000 = 60\% \times \$5,000 = \$3,000$ taxable interest).

TAX-FREE INTEREST PHASE OUT The tax-free interest is phased out when the taxpayer reaches certain levels of Modified AGI. It is phased out when the Modified AGI is between \$67,100 and \$82,100 for single or head of household taxpayers, and between \$100,650 and \$130,650 for married taxpayers. These phase-out levels are adjusted yearly for inflation.

QUALIFIED EXPENSES Qualified education expenses for the purpose of this tax benefit are defined as tuition and related fees at an eligible educational institution. For tax years beginning after December 31, 1997, the transfer of bond redemption proceeds to a QTP or to a CESA for the taxpayer, the taxpayer's spouse, or taxpayer's dependent is considered a qualified education expense. These expenses must be reduced by expenses used in the calculation of the HC and LC.

ELIGIBLE STUDENTS To be eligible for the tax-free interest benefit the student must be the taxpayer, the taxpayer's spouse, or the taxpayer's dependent and the student must have been enrolled at an eligible institution.

Married taxpayers must file a joint return to be eligible for the tax-free redemption

ELIGIBLE EDUCATIONAL INSTITUTIONS An eligible educational institution is the same definition for this tax benefit as the definition for the HC or LC.

INTERACTION WITH OTHER EDUCATION TAX BENEFITS The amount of tax-free interest claimed by the taxpayer will reduce the qualified expenses for tax-free distributions from CESAs and QTPs and reduce qualified expenses used in the calculation of the HC and LC.

FINANCIAL AID CONSEQUENCES Some taxpayers may feel that investing for future college costs (tuition and fees only) with U.S. EE Savings Bonds may be preferable to other methods of saving.

If the bonds are in the parent's name, the value of the U.S. EE Savings Bonds, at the date of signing the financial aid application will be assessed at the parents' rate of 5.6%. A loss in financial aid eligibility, the value of the savings bonds times the rate of 5.6%, will result.

For example, if a parent has \$10,000 in U.S. EE Savings Bonds at the time of filing the financial aid application form, the student will lose \$560, \$10,000 asset times 5.6% assessment rate, in financial aid eligibility.

If the U.S. EE Savings Bonds are redeemed during college years, only the interest

portion of the withdrawal will be considered financial aid income; this financial aid income will be assessed at the parents' 47% rate.

For example, if the parents redeem \$10,000 in U.S. EE Savings Bonds, including \$4,000 in tax-free interest, to help pay for college, the student will lose \$1,880 ($\$4,000 \times 47\%$) in financial aid eligibility. The bond principal will not be assessed upon redemption.

