

Tax Breaks for College

We don't need to tell you that college costs are skyrocketing. However, Washington has eased the pain a bit in recent years by offering up some attractive tax breaks to those trying to pay the college bills.

Sadly, many parents are missing these breaks and hence the opportunity to save. The U.S. Government Accountability Office reported that almost 30% of eligible tax filers missed deductions and credits intended to help defray the cost of college.

The information below will hopefully help prevent such oversights, but be sure to initiate this conversation with your tax preparer as well. In other words, at tax time, ask a qualified tax preparer about credits and deductions for your child's college education. It is his/her job to stay on top of these deductions as they will inevitably change over time. And they're tricky – sometimes using one break precludes the use of another. There are also income thresholds that disqualify some people, and these change frequently. We have included them here as of this printing but you will need to check the thresholds at the time you pursue these breaks.

At least for now, these tax breaks can mean hundreds or even thousands of dollars in savings to qualified families.

The Major Types of Breaks

- 1) **Tax deductions** – reduces taxable income; income thresholds are generally higher so these are available to more people;
- 2) **Tax credits** – reduces the amount of income tax you have to pay; usually the most desirable since they are dollar for dollar reductions in taxes paid;
- 3) **Savings plans** - Certain savings plans allow the accumulated earnings to grow tax-free until money is taken out (known as a distribution), or allow the distribution to be tax-free, or both.
- 4) **An exclusion from income** - means that you won't have to pay income tax on the benefit you're receiving, but you also won't be able to use that same tax-free benefit for a deduction or credit.

You can use the IRS's [Interactive Tax Assistant](#) tool to help determine if you're eligible for educational credits or deductions, including the American opportunity credit, the lifetime learning credit and the tuition and fees deduction.

Credits

An education credit helps with the cost of higher education by reducing the amount of tax owed on your tax return. If the credit reduces your tax to less than zero, you may get a refund. There are two education credits available: the [American Opportunity Tax Credit](#) and the [Lifetime Learning Credit](#).

Who Can Claim an Education Credit?

There are additional rules for each credit, but you must meet all three of the following for either credit:

- You, your dependent or a third party pays qualified education expenses for higher education.
- An eligible student must be enrolled at an eligible educational institution.
- The eligible student is yourself, your spouse or a dependent you list on your tax return.
- The student must receive a form 1098-T from his/her institution

If you're eligible to claim the lifetime learning credit and are also eligible to claim the American opportunity credit for the same student in the same year, you can choose to claim either credit, but not both. You can't claim the AOTC if you were a nonresident alien for any part of the tax year unless you elect to be treated as a resident alien for federal tax purposes. For more information about AOTC and foreign students, visit [American Opportunity Tax Credit - Information for Foreign Students](#).

Deductions

Tuition and Fees Deduction

<https://www.irs.gov/uac/about-publication-970>

See IRS Publication 970 for the most recent information on this deduction, but here is an overview:

You may be able to deduct qualified education expenses paid during the year for yourself, your spouse or your dependent. You cannot claim this deduction if your filing status is married filing separately or if another person can claim an exemption for you as a dependent on his or her tax return. The qualified expenses must be for higher education.

The tuition and fees deduction can reduce the amount of your income subject to tax by up to \$4,000. This deduction, reported on Form 8917, Tuition and Fees Deduction, is taken as an adjustment to income. This means you can claim this deduction even if you do not itemize deductions on Schedule A (Form 1040). This deduction may be beneficial to you if, for example, you cannot take the lifetime learning credit because your income is too high.

You may be able to take one of the education credits for your education expenses instead of a tuition and fees deduction. You can choose the one that will give you the lower tax.

Generally, you can claim the tuition and fees deduction if all three of the following requirements are met:

- You pay qualified education expenses of higher education.
- You pay the education expenses for an eligible student.
- The eligible student is yourself, your spouse, or your dependent for whom you claim an exemption on your tax return.

You cannot claim the tuition and fees deduction if any of the following apply:

- Your filing status is married filing separately.
- Another person can claim an exemption for you as a dependent on his or her tax return. You cannot take the deduction even if the other person does not actually claim that exemption.
- Your modified adjusted gross income (MAGI) is more than \$80,000 (\$160,000 if filing a joint return).

- You were a nonresident alien for any part of the year and did not elect to be treated as a resident alien for tax purposes. More information on nonresident aliens can be found in [Publication 519, U.S. Tax Guide for Aliens](#).
- You or anyone else claims an education credit for expenses of the student for whom the qualified education expenses were paid.

Student-activity fees and expenses for course-related books, supplies and equipment are included in qualified education expenses only if the fees and expenses must be paid to the institution as a condition of enrollment or attendance.

Student Loan Interest Deduction

Generally, personal interest you pay, other than certain mortgage interest, is not deductible on your tax return. However, if your modified adjusted gross income (MAGI) is less than \$75,000 (\$150,000 if filing a joint return), there is a special deduction allowed for paying interest on a student loan (also known as an education loan) used for higher education. Student loan interest is interest you paid during the year on a qualified student loan. It includes both required and voluntary interest payments.

For most taxpayers, MAGI is the adjusted gross income as figured on their federal income tax return before subtracting any deduction for student loan interest. This deduction can reduce the amount of your income subject to tax by up to \$2,500.

The student loan interest deduction is taken as an adjustment to income. This means you can claim this deduction even if you do not itemize deductions on Form 1040's Schedule A.

Qualified Student Loan

You may be able to deduct interest you pay on a qualified student loan. Generally, the amount you may deduct is the lesser of \$2,500 or the amount of interest you actually paid. It is subject to a phase-out, which means the amount of the deduction gradually decreases and phases out completely if and when your modified adjusted gross income (MAGI) amount reaches the annual limit.

You claim this deduction as an adjustment to income, so you do not need to itemize your deductions on [Form 1040, Schedule A \(PDF\)](#), *Itemized Deductions*.

You can generally claim the deduction if all of the following apply:

- You paid interest on a qualified student loan in tax year
- You are legally obligated to pay interest on a qualified student loan
- Your filing status is not married filing separately
- Your MAGI is less than a specified amount which is set annually, and
- You or your spouse, if filing jointly, cannot be claimed as dependents on someone else's return

Qualified Education Expenses

For purposes of the student loan interest deduction, these expenses are the total costs of attending an eligible educational institution, including graduate school. They include amounts paid for the following items:

- Tuition and fees
- Room and board
- Books, supplies and equipment
- Other necessary expenses (such as transportation).

The cost of room and board qualifies only to the extent that it is not more than the greater of:

- The allowance for room and board, as determined by the eligible educational institution, that was included in the cost of attendance (for federal financial aid purposes) for a particular academic period and living arrangement of the student, or
- The actual amount charged if the student is residing in housing owned or operated by the eligible educational institution.

Business Deduction for Work-Related Education

If you are an employee and can itemize your deductions, you may be able to claim a deduction for the expenses you pay for your work-related education. Your deduction will be the amount by which your qualifying work-related education expenses plus other job and certain miscellaneous expenses is greater than 2% of your adjusted gross income. An itemized deduction may reduce the amount of your income subject to tax.

If you are self-employed, you deduct your expenses for qualifying work-related education directly from your self-employment income. This may reduce the amount of your income subject to both income tax and self-employment tax.

Your work-related education expenses may also qualify you for other tax benefits, such as the tuition and fees deduction and the lifetime learning credit. You may qualify for these other benefits even if you do not meet the requirements listed above.

To claim a business deduction for work-related education, you must:

- Be working.
- Itemize your deductions on Schedule A (Form 1040 or 1040NR) if you are an employee.
- File Schedule C (Form 1040), Schedule C-EZ (Form 1040), or Schedule F (Form 1040) if you are self-employed.
- Have expenses for education that meet the requirements discussed under Qualifying Work-Related Education, below.

Qualifying Work-Related Education

You can deduct the costs of qualifying work-related education as business expenses. This is education that meets at least one of the following two tests:

- The education is required by your employer or the law to keep your present salary, status or job. The required education must serve a bona fide business purpose of your employer.
- The education maintains or improves skills needed in your present work.

However, even if the education meets one or both of the above tests, it is not qualifying work-related education if it:

- Is needed to meet the minimum educational requirements of your present trade or business or
- Is part of a program of study that will qualify you for a new trade or business.

You can deduct the costs of qualifying work-related education as a business expense even if the education could lead to a degree.

Education Required by Employer or by Law

Education you need to meet the minimum educational requirements for your present trade or business is not qualifying work-related education. Once you have met the minimum educational requirements for your job, your employer or the law may require you to get more education. This additional education is qualifying work-related education if all three of the following requirements are met.

- It is required for you to keep your present salary, status or job.
- The requirement serves a business purpose of your employer.
- The education is not part of a program that will qualify you for a new trade or business.

When you get more education than your employer or the law requires, the additional education can be qualifying work-related education only if it maintains or improves skills required in your present work.

Education to Maintain or Improve Skills

If your education is not required by your employer or the law, it can be qualifying work-related education only if it maintains or improves skills needed in your present work. This could include refresher courses, courses on current developments and academic or vocational courses.

Savings Plans

529 Plans

States sponsor 529 plans — qualified tuition programs authorized under section 529 of the Internal Revenue Code — that allow taxpayers to either prepay or contribute to an account for paying a student's qualified higher education expenses. Similarly, colleges and groups of colleges sponsor 529 plans that allow them to prepay a student's qualified education expenses. These 529 plans have, in recent years, become a popular way for parents and other family members to save for a child's college education. Though contributions to 529 plans are not deductible, there is also no income limit for contributors.

529 plan distributions are tax-free as long as they are used to pay qualified higher education expenses for a designated beneficiary. Qualified expenses include tuition, required fees, books and supplies. For someone who is at least a half-time student, room and board also qualify.

An ARRA change to tax-free college savings plans and prepaid tuition programs added to this list expenses for computer technology and equipment or Internet access and related services to be used by the student while enrolled at an eligible educational institution. Software designed for sports, games or hobbies does not qualify, unless it is predominantly educational in nature. In general, expenses for computer technology are not qualified expenses for the American opportunity credit, lifetime learning credit or tuition and fees deduction.

(See our separate manual on 529 Plans for more information)

Coverdell Education Savings Account

A Coverdell Education Savings Account (also known as an Education Savings Account, a Coverdell ESA, a Coverdell Account, or just an ESA, and formerly known as an education individual retirement account), is a tax-advantaged investment account in the United States designed to encourage savings to cover future education expenses (elementary, secondary, or college), such

as tuition, books, uniform, etc. It is found at section 530 of the [Internal Revenue Code \(26 U.S.C. § 530\)](#).

The tax treatment of Coverdell ESAs is much the same as that of [529 plans](#) with a few important differences. Like a 529 plan, Coverdell ESAs allow money to grow tax deferred and proceeds to be withdrawn tax free for qualified education expenses at a qualified institution. However the definition of qualified expenses in an ESA includes primary and secondary school, not just college and university.

Unlike a 529 plan, a Coverdell ESA can be used to pay a student's eligible k-12 expenses, as well as post-secondary expenses. On the other hand, income limits apply to contributors, and the total contributions for the beneficiary of this account cannot be more than \$2,000 in any year, no matter how many accounts have been established. A beneficiary is someone who is under age 18 or is a special needs beneficiary.

Contributions to a Coverdell ESA are not deductible, but amounts deposited in the account grow tax free until distributed. The beneficiary will not owe tax on the distributions if they are less than a beneficiary's qualified education expenses at an eligible institution. This benefit applies to qualified higher education expenses as well as to qualified elementary and secondary education expenses.

Here are some things to remember about distributions from Coverdell accounts:

- Distributions are tax-free as long as they are used for qualified education expenses, such as tuition and fees, required books, supplies and equipment and qualified expenses for room and board.
- There is no tax on distributions if they are for enrollment or attendance at an eligible educational institution. This includes any public, private or religious school that provides elementary or secondary education as determined under state law. Virtually all accredited public, nonprofit and proprietary (privately owned profit-making) post-secondary institutions are eligible.
- Education tax credits can be claimed in the same year the beneficiary takes a tax-free distribution from a Coverdell ESA, as long as the same expenses are not used for both benefits.
- If the distribution exceeds qualified education expenses, a portion will be taxable to the beneficiary and will usually be subject to an additional 10% tax. Exceptions to the additional 10% tax include the death or disability of the beneficiary or if the beneficiary receives a qualified scholarship.

For more information, see [Topic 310 – Coverdell Education Savings Accounts](#).

Scholarships and Fellowships

A scholarship is generally an amount paid or allowed to, or for the benefit of, a student at an educational institution to aid in the pursuit of studies. The student may be either an undergraduate or a graduate. A fellowship is generally an amount paid for the benefit of an individual to aid in the pursuit of study or research. Generally, whether the amount is tax free or taxable depends on the expense paid with the amount and whether you are a degree candidate.

A scholarship or fellowship is tax free only if you meet the following conditions:

- You are a candidate for a degree at an eligible educational institution.
- You use the scholarship or fellowship to pay qualified education expenses.

Qualified Education Expenses

For purposes of tax-free scholarships and fellowships, these are expenses for:

- Tuition and fees required to enroll at or attend an eligible educational institution.
- Course-related expenses, such as fees, books, supplies, and equipment that are required for the courses at the eligible educational institution. These items must be required of all students in your course of instruction.

However, in order for these to be qualified education expenses, the terms of the scholarship or fellowship cannot require that it be used for other purposes, such as room and board, or specify that it cannot be used for tuition or course-related expenses.

Expenses that Don't Qualify

Qualified education expenses do not include the cost of:

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

This is true even if the fee must be paid to the institution as a condition of enrollment or attendance. Scholarship or fellowship amounts used to pay these costs are taxable.

For more information, see Pub. 970.

Exclusions from Income & Credits

You may exclude certain educational assistance benefits from your income. That means that you won't have to pay any tax on them. However, it also means that you can't use any of the tax-free education expenses as the basis for any other deduction or credit, including the lifetime learning credit.

Employer-Provided Educational Assistance

If you receive educational assistance benefits from your employer under an educational assistance program, you can exclude up to \$5,250 of those benefits each year. This means your employer should not include the benefits with your wages, tips, and other compensation shown in box 1 of your Form W-2.

Educational Assistance Program

To qualify as an educational assistance program, the plan must be written and must meet certain other requirements. Your employer can tell you whether there is a qualified program where you work.

Educational Assistance Benefits

Tax-free educational assistance benefits include payments for tuition, fees and similar expenses, books, supplies, and equipment. The payments may be for either undergraduate- or graduate-level courses. The payments do not have to be for work-related courses. Educational assistance benefits do not include payments for the following items.

- Meals, lodging, or transportation.

- Tools or supplies (other than textbooks) that you can keep after completing the course of instruction.
- Courses involving sports, games, or hobbies unless they:
 - Have a reasonable relationship to the business of your employer, or
 - Are required as part of a degree program.

Benefits over \$5,250

If your employer pays more than \$5,250 for educational benefits for you during the year, you must generally pay tax on the amount over \$5,250. Your employer should include in your wages (Form W-2, box 1) the amount that you must include in income.

Working Condition Fringe Benefit

However, if the benefits over \$5,250 also qualify as a working condition fringe benefit, your employer does not have to include them in your wages. A working condition fringe benefit is a benefit which, had you paid for it, you could deduct as an employee business expense. For more information on working condition fringe benefits, see *Working Condition Benefits* in chapter 2 of Publication 15-B, Employer's Tax Guide to Fringe Benefits.

Finally, here is a summary of which education level qualifies for which tax break:

The Tax Break	Eligible Education
American Opportunity Credit	Undergraduate, graduate
Lifetime Learning Credit	undergraduate, graduate, and job-related classes
Education Deduction	undergraduate, graduate, and individual classes
Student Loan Interest Deduction	undergraduate, graduate
Section 529 Plan Distributions	undergraduate, graduate
Education Savings Accounts	K-12, undergraduate, graduate
Employer Provided Tuition	undergraduate, graduate

Visit this link to further research the above: <https://www.irs.gov/publications/p970/ch03.html>

Note: The financial information in this manual is of a general nature and may not apply to all situations. In addition, tax rules changes frequently so we cannot guarantee that the information is current at all times. Contact a financial and/or tax advisor to be sure you have the most current information before making significant decisions.