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Tax Breaks for Higher Education

Client Information Series

Deduction For Interest

Generally, taxpayers can only deduct home mortgage interest, investment interest, and business interest. However, interest paid on student loans used to pay tuition, room and board, and related expenses for qualified higher education is deductible even if the taxpayer uses the standard deduction. The amount deductible was initially limited to $1,000 in 1998 and has gradually increased so that up to $2,500 is deductible in 2001 and after.

Note: Student loan interest is not limited to government student loans and could be home equity loans, credit card debt, etc., provided the debt was incurred solely to pay qualified higher education expenses.

The deduction for a student loan interest was initially limited to the first 60 months in which payments are required. However, beginning in 2002, that restriction has been removed.

The annual deduction begins to phase out when modified AGI is between $50,000 and $65,000 ($40,000 and $55,000 for years prior to 2002) for single taxpayers and between $100,000 and $130,000 (60,000 and $75,000 for years prior to 2002) for joint return filers. The modified AGI levels will be inflation-adjusted after the year 2002.

Educational Tax Credits

The law provides for two nonrefundable tax credits, the Hope Scholarship and the Lifetime Learning Credits, as explained on the following panel. Both credits will reduce a taxpayer's tax liability dollar for dollar until the tax reaches zero. Any credit in excess of the tax liability is lost. The credit is not allowed for taxpayers who file married separate returns.

The credits are elective, and the taxpayer must choose between the two credits for each student. In general, most taxpayers will find it more beneficial to take the Hope Scholarship Credit in the first two years of the student's education and the Lifetime Learning Credit after the first two years.

The allowable credits phase-out when a taxpayer's modified AGI is between $40,000 and $50,000 for single taxpayers and between $80,000 and $100,000 for joint return filers. These phase-out levels are subject to annual inflation adjustment. For example, the 2003 phase-out range for single filers is $41,000 - $51,000; for married joint filers the range is $83,000 - $103,000.

Hope Scholarship Credit

The Hope Scholarship Credit is a credit of up to $1,500 per student per year, covering the first two years of post-secondary education. The credit is 100% of the first $1,000 of qualifying expenses plus 50% of the next $1,000.

Example: A taxpayer's child is in the first year of college, attending on a full-time basis. The tuition is $1,500, which is paid during the year by the taxpayer; there is no reimbursement or other tax benefit claimed for the tuition expense. The taxpayer is entitled to a tax credit of $1,250 (100% of the first $1,000 plus 50% of balance) for the tax year.

Lifetime Learning Credit

The Lifetime Learning Credit is a credit of up to 20% of the first $10,000 ($5,000 for tax years before 2003) of qualifying educational expenses for: (1) undergraduate, graduate, or certificate level courses for a student attending classes on at least a half-time basis; or (2) any course at an eligible institution to acquire or improve job skills of the student (no attendance time requirements). Expenses must have been incurred and paid after June 30, 1998.

Example: A taxpayer has two children attending college on a full-time basis. The taxpayer pays qualified tuition expenses for the two children in the amount of $12,000, and there is no reimbursement or other tax benefit claimed for the tuition expense. The taxpayer is entitled to a tax credit of $2,000 (20% of the first $10,000) for the tax year.

Qualifying expenses... for both credits include tuition and fees but not expenses for room, board, books, and other nonacademic fees such as student activity, athletic, insurance, etc. Also excluded are expenses for courses that involve sports, games, or hobbies that are not part of a degree program. Expenses qualifying for the credit must be reduced by tax-free scholarships or fellowships and other tax-free educational benefits.

Qualifying students... must attend a qualified educational institution (one that is eligible to participate in U.S. Dept. of Education student aid programs). The student must be the taxpayer, spouse, or someone who is a dependent of the taxpayer. In addition, in the case of the Hope Scholarship Credit, the student must have no federal or state felony drug convictions for the academic period to which the credit would apply.

Savings Bond Interest Exclusion

Interest earned on U.S. savings bonds is, by federal law, excludable from taxation for state income tax purposes but taxable on the federal return. However, for certain savings bonds, an individual can even exclude the interest on the federal return. To qualify for this Federal exclusion, the bonds must be Series EE U.S. savings bonds issued after 1989, or a series I Bond and the bond proceeds must be used to pay higher education expenses.

Other qualifications... The bond purchaser must be age 24 or over and must be the sole owner of the bond (or, if married, joint owner with a spouse). Bonds purchased by others (except the spouse) or purchased by the taxpayer and placed in another's name do not qualify for the exclusion.

Redemption of bonds... When the bonds are redeemed, the interest earned is excludable from income to the extent the proceeds are used to pay qualified higher education expenses for the taxpayer, spouse, or any dependent of the taxpayer. Such expenses include tuition and fees but not room and board or courses involving sports, etc., that aren't part of a degree program.

Phase-out... Like so many of the other educational benefits described earlier in this brochure, the interest exclusion phases out when modified AGI is between certain inflation-adjusted limits. For 2003, the phase-out occurs between $58,500 and $73,500 for single taxpayers and between $87,750 and $117,750 for married taxpayers filing joint returns.

Above-the-Line Education Deduction-Through 2005 Only

A deduction from the gross income of up to a maximum of $4,000 is allowable in years 2004 and 2005 for higher education tuition expenses (same definition as for the education credits). This deduction is phased out for higher earning tax payers and is not allowed in years when education credits are claimed.

The purpose of this pamphlet is to provide current information on tax, financial, and business developments. It suggests general tax planning ideas that may be appropriate in certain situations. The information and opinions are generalizations and may not apply to all taxpayers; it is important that you seek appropriate advice before implementing any of the ideas suggested.

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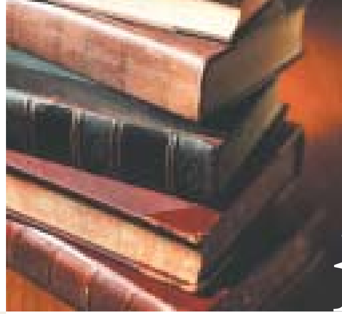

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The 1997 Tax Act included several tax breaks for students and their parents. Those benefits, combined with other benefits in existence at the time, provided taxpayers with a large number of options for tax-favored financing of their education and the education of their family members. The Tax Act of 2001 further enhanced those tax benefits and opened them up to a larger segment of the population. This brochure highlights the various education benefits included within the U.S. income tax system.

- **Coverdell Education Savings Account (Education IRA)**
- **Qualified State Tuition Program**
- **Hope Scholarship Program**
- **Lifetime Learning Credit**
- **Penalty Free IRA Withdrawals for Education Purposes**
- **Deduction for Education Loan Interest**
- **Tax Free Savings Bond Interest**

Student aid is available from the Department of Education for students of limited means. The aid can include educational grants such as a "Pell" grant or various types of student and parent educational loans. Planning and saving for future education can limit or eliminate potential student aid, because these resources will be taken into consideration at the time the need for student aid is determined.

Understanding the tax terms: You will encounter several tax terms in this brochure that may be unfamiliar to you. Understanding their full meaning will help give you a better picture of the limits, qualifications, and restrictions that apply to the benefits for education.

Phase Out... Instead of just eliminating certain deductions and credits, the tax law often decreases them gradually to zero ("phases them out") over a specific income range. For example, say a hypothetical $1,000 deduction is allowed, but "phases out" when a taxpayer's "modified adjusted gross income (AGI)" is between $40,000 and $60,000. A taxpayer with a modified AGI of $40,000 or less will be allowed the full $1,000 deduction, while the taxpayer with a modified AGI of $60,000 or more would get no deduction. For modified AGIs between $40,000 and $60,000 the taxpayer would be allowed a pro-rated deduction amount.

Regular AGI and Modified AGI... AGI is the abbreviation for "adjusted gross income." "Regular AGI" is the total of all income, allowable losses, and adjustments before subtracting itemized or standard deductions and personal exemptions. However, several tax benefits described in this brochure are limited or not available to taxpayers whose so-called "modified AGI" is too high. Generally, the modified AGI for educational benefits adds back certain income from foreign, U.S. Possession, and Puerto Rican sources that is excluded from income.

Qualified Educational Institutions... These Institutions are generally accredited, post-secondary educational institutions that offer credit toward a bachelor's degree, an associate's degree, or some other recognized post-secondary credential. Certain proprietary institutions and post-secondary vocational institutions also qualify if they are eligible to participate in Department of Education student aid programs.

Coverdell Education Savings Account

Although originally referred to as an Education IRA, the Coverdell Education Savings Account is really a nondeductible education savings account. The investment earnings from this account accrue and are withdrawn tax-free. The proceeds are used to pay qualified education expenses of the account beneficiary.

These accounts first became available in 1998, and nondeductible contributions of up to $500 were permitted per year for the benefit of the designated beneficiary. Beginning in 2002, the allowable nondeductible contribution has been increased to $2,000 per year per beneficiary. Contributions are only allowed for designated beneficiaries under the age of 18.

The annual contribution limit is gradually reduced if the contributing taxpayer's "modified AGI" is within the phase-out range and eliminated for taxpayers above the range. Initially in 1998, the phase-out range for single taxpayers was $95,000 - $110,000, and $150,000 - $160,000 for married taxpayers. Beginning in 2002, the phase-out limits for married taxpayers has been increased to $190,000 - $220,000, while the single phase-out range remains unchanged. Anyone is allowed to make the contribution provided the total contribution for the under 18 beneficiary does not exceed the annual contribution limit and the contributing taxpayer's AGI is within limits. If the AGI limits the contribution, the funds can be gifted to someone else whose contribution would not be AGI limited, even the beneficiary.

Distributions from the Coverdell Education Savings Account are tax-and penalty-free (including interest on the account) if they are used to pay for qualified education expenses of the designated beneficiary or a member of the beneficiary's family.

Prior to 2002, the definition of qualified education expenses was limited to higher education. However, beginning in 2002, the definition has been expanded to include elementary or secondary education, kindergarten through grade 12.

Under the pre-2002 rules, contributions to these accounts had to be made before the end of the year to which they applied. This created difficulty for taxpayers who did not know if they qualified to make a contribution until after year's-end. Recognizing that problem, Congress changed the date to April 15 of the following tax year for tax years after 2001.

Additional rules apply for dealing with rollovers, changes in designated beneficiaries, death of taxpayer or beneficiary, excess contributions, special needs beneficiaries, and unauthorized use of distributions.

Qualified State Tuition Programs

A qualified state tuition program is one generally set up by a state or state instrumentality that lets individuals make contributions to an account established for a designated beneficiary's higher education.

Unlike the Coverdell Education Savings Account, there is no limit on the annual contributions to Qualified State Tuition programs.

However, contributions to these plans are considered gifts to the beneficiary, making the annual gift exclusion amount the practical annual limit per contributor. The long-standing annual gift exclusion amount of $10,000 is now inflation-adjusted; the current annual limit is $11,000. A special rule allows a donor who makes total contributions exceeding the annual gift limit to elect to take the contributions into account ratably over a five-year period, starting with the year of the contribution. This allows a donor to contribute as much as $55,000 ($50,000 before 2002) in one year, while avoiding the gift tax implications. The donor must file a gift tax return for the year of the contribution, and a five-year election must be made on the return. Care should be exercised in determining the total contributed to any individual's account to avoid nonqualified distributions if the amount exceeds the educational needs.

Virtually all of the high population states now have these programs, which are professionally managed and tailor the investments and risk potential to the potential student's current age. Individuals are not restricted to using the program established in their home state but instead can pick and choose among the programs of any of the states that have established programs.

The benefit of these programs was significantly enhanced for years after 2003 when the distributions of earnings from the programs can be excluded from income if used for qualified expenses. This is a big change from prior rules where the earnings from the accounts were taxable to the beneficiary when withdrawn. This puts the Qualified State Tuition Programs on par with Coverdell Education Savings Accounts, but without the annual contribution limit. Additional rules apply for designated beneficiaries, death of taxpayer or beneficiary, and unauthorized use of distributions.

Penalty-Free IRA Withdrawals

Generally, when funds are withdrawn from an IRA before a taxpayer reaches age 59½, a 10% early withdrawal penalty applies to the distribution. For tax years beginning in 1998, penalty-free withdrawals will be permitted if the funds are used to pay qualified higher education expenses. The withdrawals will still be subject to regular income tax.

Qualified "higher education expenses" include tuition at a qualified educational institution, as well as related room, board, fees, books, supplies, and equipment. The expenses can be for the taxpayer, spouse, or taxpayer's or spouse's children and grandchildren.