TAX SAVINGS FOR EDUCATION

Since *Planning Your Career* was last revised, there have been significant changes in the federal tax laws concerning post-secondary education. Therefore, we are including this information sheet to update the material in Chapters 19 and 20 of your textbook.

<u>Tax credits for tuition and fees:</u>

There are two non-refundable tax credits available to students and their families for payments made for tuition and fees at eligible post-secondary institutions. These are called the HOPE Scholarship Credit and the Lifetime Learning Credit. Please note that the HOPE Scholarship Credit is <u>not</u> an actual scholarship. Like the Lifetime Learning Credit, the HOPE Scholarship Credit is simply a tax credit which can be subtracted from the amount of tax an individual or family otherwise owes.

The tax credits are available for eligible expenses for the taxpayer, the taxpayer's spouse, or a dependent of the taxpayer. Eligible expenses include tuition and fees, but do <u>not</u> include the cost of such things as room and board, books and transportation. A taxpayer can only choose to claim one of these tax credits per eligible student during any given year. To claim either credit, the taxpayer must provide the name and taxpayer identification number (Social Security number) of the student when filing his or her federal income tax return. Educational institutions are required separately to report information concerning tuition and related expenses to the IRS.

Both of these tax credits are "non-refundable." In other words, these tax credits can only be used to reduce the amount of tax owed. Thus a taxpayer or family must make enough money to pay taxes in order to take advantage of them.

Both tax credits are graduated according to income. Individuals whose adjusted gross income is below $40,000 and joint taxpayers whose adjusted gross income is below $80,000 are entitled to the full tax credit. The amount individuals and joint taxpayers may claim is gradually reduced as their adjusted gross income increases. The tax credit is completely phased out for individuals with adjusted gross incomes above $50,000 and joint taxpayers with adjusted gross incomes over $100,000.

What are the differences between the two tax credits?

The HOPE Scholarship Credit can only be used for the first two years of college education. After the first two years, the Lifetime Learning Credit must be claimed.

For the HOPE Scholarship Credit, a taxpayer may claim up to $1,500 per tax year for each eligible dependent. This includes 100% of the first $1,000 of eligible expenses and 50% of the next $1,000 of eligible expenses. A student for whom this credit is being claimed must be enrolled on at least a half-time basis for at least one academic period during the year for the expenses to qualify.

For the Lifetime Learning Credit, a taxpayer may claim a maximum credit of $1,000 per tax year ($2,000 beginning in 2003) for each eligible dependent. This is calculated on the basis of 20% of up to $5,000 of eligible expenses for the taxable year ($10,000 beginning in 2003). Thus if there were $1,000 of eligible expenses in a given year, the taxpayer could claim a tax credit of 20% of $1,000 or $200. Eligible programs of study for this tax credit include courses of instruction to acquire or improve job skills.

The HOPE Scholarship Credit applies to tuition and fees paid for educational programs beginning after December 31, 1997. The Lifetime Learning Credit applies to tuition and fees paid for educational programs beginning after June 30, 1998.

Deduction for Interest on Education Loans:

Up to $2,500 in interest on qualified educational loans can be deducted (Note that this is not a tax credit, but an itemized deduction). This $2,500 maximum is being phased in over 4 years (the maximum deduction in 1998 is $1,000; in 1999, $1,500; in 2,000, $2,000, and in 2001, $2,500). This applies, however, only to interest, which is due and paid after December 31, 1997. Taxpayers can take this deduction on qualified educational loans taken out for their benefit, the benefit of their spouse, or the benefit of anyone who was a dependent of the taxpayer at the time the loan was taken out. Deductions are only allowed, however, for the first 5 years that interest is required.

Education IRA's:

Taxpayers can set up special IRA's (IRA stands for Individual Retirement Account) designed not to provide money for retirement, but to provide qualified higher education expenses for someone they designate (their beneficiary). Qualified expenses include tuition, fees, books, supplies and equipment, and room and board. Annual contributions of up to $500 can be made per beneficiary under the age of 18 (there are certain income restrictions on this). The advantage of this IRA is that the interest earned is non-taxable until the money in the IRA starts to be spent. But even in this case, if the money withdrawn does not exceed the qualified higher education expenses of the eligible student for the year, the money withdrawn will not count as income (and thus will not be taxed).

If, however, it turns out that money withdrawn is not used for higher education, the taxpayer must not only pay any tax owed but a 10% penalty as well.