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A GUIDE TO TAX BENEFITS for higher education

The Taxpayer Relief Act contains a number of provisions that will help families who are either preparing for or are already paying for the ever-rising costs of higher education. This relatively recent legislation also provides benefits to those who are repaying student loans. Naturally, the amount of benefits will vary for each family depending on individual income and other circumstances, but there's something in the Taxpayer Relief Act for many families.

Find out if you can benefit from one or more of them.

The Hope Scholarship Tax Credit

The Hope Scholarship Credit offers a tax reduction. If you don't already know it, a tax credit is not a tax deduction, but a dollar-for-dollar credit against taxes due. The effective date for the Hope Scholarship Credit was January 1, 1998. Since then, some taxpayers may be eligible to receive a non-refundable credit against federal income taxes.

The tax credit is available to eligible taxpayers. Eligibility is defined as a student who is the taxpayer, the taxpayer's spouse or a taxpayer's dependent, if the taxpayer is allowed a tax exemption. To be eligible, students must meet the following criteria:

- be enrolled at least half time
- in the first or second year of a postsecondary program leading to a degree, certificate or other recognized educational credential
- at an eligible school (virtually all accredited schools are eligible)
- for academic periods beginning on or after January 1, 1998.

The amount of savings depends on a few factors and there are some income limitations. For example, the amount the taxpayer may claim as a Hope Credit is slightly reduced when the modified adjusted gross income is between $41,000 and $51,000 per year ($82,000 to $102,000 for married taxpayers filing jointly). If the modified adjusted gross income is $51,000 or more ($102,000 or more for married taxpayers filing jointly), the taxpayer may not take the credit. Here is the formula:

The amount of the Hope Tax Credit is 100% of the first $1,000 of the taxpayer's qualified "out-of-pocket" expenses for each student in the taxpayer's family (taxpayer, spouse or eligible dependent). An additional 50% of the next $1,000 of the taxpayer's qualified expenses for each student is also eligible. The credit applies to net tuition and required fees (less grant aid). Thus, the credit may be worth as much as $1,500 for each eligible student.

If, for example, a family has two eligible students, the credit is $3,000. For three eligible students, it is $4,500, etc. When calculating the credit, the eligible student may use only paid "out-of-pocket" expenses. Expenses that qualify when calculating the credit include those paid for with the student's earnings, a loan, a gift, an inheritance or personal savings (including savings from a qualified state tuition plan).

Tax-free employer-provided tuition payments, Federal Pell Grants or tax-free scholarships may not be used to calculate the credit. If the student receives a tax-free distribution from a Coverdell ESA, none of the student's expenses may be claimed. However, if the student elects to pay the taxes due on the Coverdell ESA distribution, the expenses may be claimed when calculating the credit. Either the parent or the dependent may claim the Hope Scholarship Credit, but not both. To be eligible for the credit, married taxpayers must file a joint return. Eligible taxpayers may apply for either the Hope Scholarship Credit or the Lifetime Learning Credit, but not both in the same year.

Hope Scholarship Tax Credit – Summary

Effective Date: Qualified expenses paid on or after January 1, 1998.

Qualifying Expenses: Tuition and required academic fees only.

Taxpayer Eligibility: Tax credit may be claimed by the taxpayer, the taxpayer's spouse or dependents. Generally, a non-U.S. resident alien is not eligible.

School Eligibility: An institution (i.e., college, university, vocational school) must be eligible to participate in student aid programs administered by the U.S. Department of Education.

Enrollment Status: Enrolled at least half time in a program leading to a degree, certificate or other recognized educational credential and only for the first two years of postsecondary education.

Income Limits: Amount of credit taxpayer can claim is gradually reduced when modified adjusted gross income is between $41,000-$51,000 ($82,000-$102,000 for married taxpayers filing jointly). Taxpayers with modified adjusted gross incomes of $51,000 or more (of $102,000 or more for married taxpayers filing jointly) are not eligible.

Calculation of Tax Credit: 100% of first $1,000 and 50% of next $1,000 of qualified expenses with a maximum of $1,500 per student.

Other Restrictions: Only "out-of-pocket" expenses can be considered. Qualified expenses that are paid with the Federal Pell Grant or other tax-free scholarship, tax-free Coverdell ESA distribution or tax-free employer-provided educational assistance cannot be used in calculating this tax credit. During the same year, a student's expenses cannot be claimed for both the Hope Scholarship and Lifetime Learning Tax Credits.

Lifetime Learning Tax Credit

The Lifetime Learning Tax Credit targets a different group of students but is a valuable benefit nonetheless. Instead of benefiting first-year and sophomore college students, this tax credit is designed to provide financial assistance to college juniors and seniors, graduate and professional degree students and adults who want to return to school to update their skills or change careers. Unlike the Hope Scholarship Tax Credit, the Lifetime Learning Credit is calculated on a per-taxpayer (family) basis, regardless of the number of postsecondary students in the family.

Here's how it is calculated: A family will receive a 20% tax credit for the first $10,000 for tuition and required fees paid each year through 2003. As with the Hope Scholarship Credit, the Lifetime Learning Credit is available for net tuition and required academic fees (less grant aid). The credit may be taken for amounts paid on or after July 1, 1998, for college or vocational school enrollment beginning on or after July 1, 1998. The maximum credit is determined on a per-taxpayer (family) basis, regardless of the number of postsecondary students in the family. It is phased out at the same income levels as the Hope Scholarship Credit. Families are able to claim the Lifetime Learning Credit for some members of their family and the Hope Scholarship Credit for others who qualify in the same year.

Lifetime Learning Tax Credit – Summary

Effective Date: Qualified expenses paid on or after July 1, 1998.

Qualifying Expenses: Tuition and required academic fees only.

Taxpayer Eligibility: Tax credit may be claimed by the taxpayer, the taxpayer's spouse or dependents. Generally, a non-U.S. resident alien is not eligible.

School Eligibility: An institution (i.e., college, university, vocational school) must be eligible to participate in student aid programs administered by the U.S. Department of Education.

Enrollment Status: Enrolled in at least one postsecondary course.

Income Limits: Amount of credit taxpayer can claim is gradually reduced when modified adjusted gross income is between $41,000-$51,000 ($82,000-$102,000 for married taxpayers filing jointly). Taxpayers with modified adjusted gross incomes of $51,000 or more (of $102,000 or more for married taxpayers filing jointly) are not eligible.

Calculation of Tax Credit: 20% of first $10,000 of qualified expenses with a maximum of $2,000 per family.

Other Restrictions: Only "out-of-pocket" expenses can be considered. Qualified expenses paid with the Federal Pell Grant or other tax-free scholarship, tax-free Coverdell ESA or tax-free employer-provided educational assistance cannot be used in calculating this tax credit. During the same year, a student's expenses cannot be claimed for both the Hope Scholarship and Lifetime Learning Tax Credits.

Coverdell Education Savings Account (ESA)

A Coverdell ESA (formerly known as an Education IRA) is another innovation that helps make it easier to pay the increasing costs of higher education. Family members (this includes parents, grandparents, other family members, friends and the child) may deposit up to, but not more than, $2,000 per year, into a Coverdell ESA in the child's name for each child under the age of 18. Special rules apply for contributions made for a special-needs beneficiary. While in the account, the contributions grow tax-free. Withdrawals are tax-free, too, but only if the child's qualified educational expenses for the year equal or exceed the amount withdrawn. If money is withdrawn and the child doesn't have any expenses or if more than the qualified expenses are withdrawn in a particular year, the excess amount is subject to income tax and an additional tax of 10%. Money contributed to a Coverdell ESA may not be taken as a tax deduction.

Coverdell ESAs have some limitations based on adjusted gross income. The $2,000 contribution is adjusted downward if a taxpayer's modified adjusted gross income is between $95,000 and $110,000 (between $190,000 and $220,000 for married taxpayers filing jointly). If the modified adjusted gross income is above these amounts, taxpayers are ineligible to contribute to a Coverdell ESA.

Once a child reaches the age of 30 (unless for a special-needs beneficiary), the Coverdell ESA must be closed or transferred to a younger member of the family. If the child for whom the contribution is made does not need the money, it may be rolled over to another eligible family member's Coverdell ESA without taxes or penalty.

529 Plan: You may now contribute to a Coverdell ESA and a 529 Plan in the same year for the same beneficiary without penalty.

Note: During the year that money is withdrawn from a Coverdell ESA and used for eligible expenses, the recipient may not take advantage of either the Hope Scholarship or Lifetime Learning Tax Credit provided it is not used for the same expenses.

Special Rules for Regular IRAs – Withdrawals for Higher Education Expenses

Until now, premature withdrawal of money from an IRA (before the account holder reaches the age of 59-1/2) was always associated with a penalty. However, as of January 1, 1998, a taxpayer may withdraw funds from an IRA, including a Roth IRA, without penalty if the money is used for eligible education expenses for the taxpayer, taxpayer's spouse, child or even grandchild. The money withdrawn is subject to federal income tax but not the 10% penalty usually applied to early withdrawal. If the money withdrawn exceeds the eligible expenses, the excess funds are subject to the penalty. Qualified expenses that are paid with the Federal Pell Grant or other tax-free scholarship, tax-free Coverdell ESA distribution or tax-free employer-provided educational assistance are excluded from the amount available for withdrawal from an IRA without penalty. Some IRAs may have limitations concerning their establishment by certain taxpayers.

Coverdell ESA – Summary

Effective Date: Contributions of $2,000 can be made effective January 1, 2002.

Qualifying Expenses: Tuition, required fees, books, supplies and equipment for a required course of study. Room and board based on the school's published charges are allowed for students enrolled at least half time or the allowance for room and board as determined by the institution for students living off campus and not at home. Certain elementary and secondary educational expenses are allowed effective January 1, 2002. In addition, necessary expenses of a special-needs beneficiary are allowed.

Eligible Contributors: Parents, grandparents, friends or even the child may contribute to a Coverdell ESA for children under 18.

School Eligibility: An institution (i.e., college, university, vocational school) must be eligible to participate in student aid programs administered by the U.S. Department of Education.

Eligible Courses: Withdrawals may be used for any course of undergraduate, graduate or professional study.

Enrollment Status: Any enrollment status (i.e., full-time, half-time or even less than half-time).

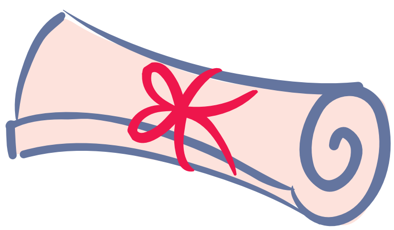
Income Limits: Coverdell ESA contributions are gradually reduced for individuals with modified adjusted gross incomes between $95,000-$110,000 (between $190,000-$220,000 for married taxpayers filing jointly). For modified adjusted gross incomes above $110,000 ($220,000 for married taxpayers filing jointly) contributions cannot be made to any Coverdell ESA.

Other Restrictions: Contributions on behalf of the same beneficiary can be made to both a Qualified Tuition Plan and a Coverdell ESA in the same year.

Student Loan Interest Deduction

Some students may now deduct the interest paid on their qualified education loans when filing their federal income tax returns. The Student Loan Interest Deduction allows students or their families to take a tax deduction for interest paid. The deduction is available even if the student does not itemize deductions.

Single filers with a modified adjusted gross income between $50,000 and $65,000 can take a partial deduction (full deduction if income is below $50,000). Married couples filing jointly with a modified adjusted gross income between $100,000 and $130,000 can also take a partial deduction. The deduction is available for all educational loans, excluding loans made from a related person.



Student Loan Interest Deduction – Summary

Effective Date: Beginning January 1, 1998, for any interest paid during the first 60 months in which interest payments are required. As of January 1, 2002, this requirement was eliminated.

Qualifying Expenses: Tuition and fees, books, supplies, equipment, room and board and other college-related expenses (such as transportation).

Taxpayer Eligibility: Taxpayers can deduct interest paid on eligible student loans for themselves, their spouses and/or their dependents.

School Eligibility: An institution (i.e., college, university, vocational school) must be eligible to participate in student aid programs administered by the U.S. Department of Education.

Income Limits: Amount of deduction claimed is gradually reduced for taxpayers with modified adjusted gross incomes between $50,000-$60,000 ($100,000-$130,000 for married taxpayers filing jointly). Higher income taxpayers cannot claim an interest deduction.

Calculation of Deduction: Maximum deductions for a taxpayer are as follows: $2,500 in 2001 and beyond.

Other Restrictions: When a taxpayer is claimed as a dependent on another taxpayer's return in any taxable year, an interest deduction cannot be claimed by the original taxpayer.

Qualified Tuition Program (QTP) - Summary

See back page for description

Effective Date: January 1, 1998, except for the new provision allowing savings for room and board expenses effective retroactive to August 20, 1996.

Qualifying Expenses: Tuition and fees, books, supplies and equipment for a required course of study. Room and board based on the cost of attendance (for federal financial aid purposes) are allowed for students enrolled at least half time. Note: Necessary expenses of a special-needs beneficiary are allowed.

Eligible Contributors/Beneficiaries: Parents, grandparents, friends or even the child may contribute to a QTP. The beneficiary will pay taxes upon fund disbursement.

School Eligibility: An institution (i.e., college, university, vocational school) must be eligible to participate in student aid programs administered by the U.S. Department of Education.

Eligible Courses: Funds may be used for any course of undergraduate, graduate or professional study.

Enrollment Status: Any enrollment status (i.e., full-time, half-time or even less than half-time).

Income Limits: Not applicable.

Other Restrictions: Contributions on behalf of the same beneficiary cannot be made to both a QTP and a Coverdell ESA in the same year.

Employee Tuition Assistance

The Tax Relief Act also extends Section 127 of the tax code for three years. This section allows workers to exclude up to $5,250 of the employer-provided education benefits from their incomes. The assistance applies to undergraduate and graduate courses beginning after December 31, 2001. The education need not be job-related. The Hope Scholarship and the Lifetime Learning Credits may not be claimed for the year in which the employer pays all the education expenses that would otherwise be eligible for these credits.

Employee Tuition Assistance – Summary

Effective Date: Already in effect.

Qualifying Expenses: Tuition and fees, books, supplies and equipment for a required course of study. Room and board based on the school's published charges are allowed for students enrolled at least half-time.

Eligible Beneficiaries/Limits: Tax-free education assistance can be provided by any employer who has a written policy of up to $5,250 annually to each employee on a tax-free basis.

School Eligibility: An institution (i.e., college, university, vocational school) must be eligible to participate in student aid programs administered by the U.S. Department of Education.

Eligible Courses: For undergraduate and graduate courses only. Consult your tax advisor.

Enrollment Status: Any enrollment status (i.e., full-time, half-time or even less than half-time).

Income Limits: Not applicable.

Other Restrictions: A deduction cannot be taken when tax-free benefits are received under an employer's qualified educational assistance program.

Qualified Tuition Program

Formerly known as the
Qualifed State-sponsored Tuition Plan

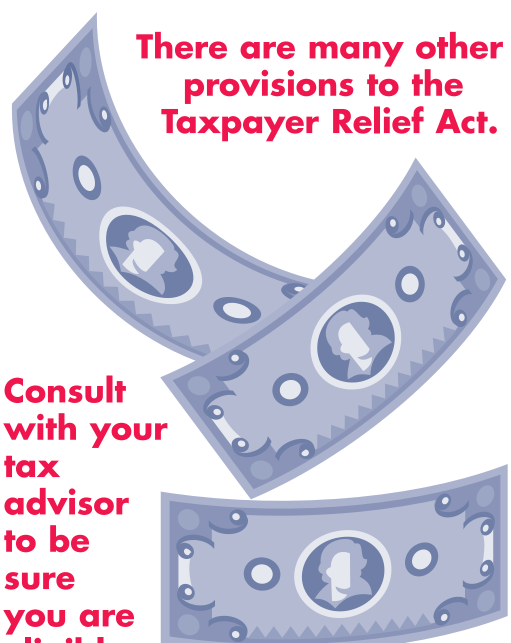
A Qualified Tuition Plan (QTP) allows the participant to:

- contribute to an account that is established for paying qualified higher education expenses of the beneficiary (or)
- prepay tuition benefits on behalf of a student so that the student is entitled to a waiver or a payment of qualified higher education expenses.

No tax is due in connection with the plan until the money is withdrawn. As of January 1, 1998, families are allowed to use these plans to save not only for tuition but also for certain room and board expenses for students who attend college at least half time.

Tuition and required fees paid with withdrawals from such a plan are eligible for both the Hope Scholarship and the Lifetime Learning Tax Credits. Contributions for the same student may not be made to both a QTP and a Coverdell ESA in the same year.

There are many other provisions to the Taxpayer Relief Act.



Consult with your tax advisor to be sure you are eligible for any of these taxpayer benefits.