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August 2004 - Maximizing Education Credits and Deductions

At this time of year when thoughts return to school, it is a good time to review the various education credits and deductions available to reduce your taxes. Many of these have changed since I wrote about this last in April 2000. Which of these programs are best for you depends on a number of factors, most notably income and timing. I will summarize them here, but since the rules are complex and often conflicting, I would urge you to get additional information so that you can maximize your benefits.

Higher Education Tax Credits

Two different education tax credits are available for you, your spouse, or someone you claim as your dependent. These are the Hope credit and the Lifetime Learning Credit.

The Hope credit is available for students in the first two years of a higher education program leading to a degree, certificate, or other recognized educational credential. For at least one quarter or semester beginning in the calendar year, the student must take at least a half-time course load as defined by the educational institution. If a student begins a program in the fall of tax year 1, continues through tax year 2, and completes the first two years of the program in the spring or summer of tax year 3, you can claim any two but not all three of these tax years for the Hope credit. Keep this in mind when deciding whether to claim the Hope credit for a first tax year that includes only one semester or quarter of study.

It can also be important to note that the Hope credit is only available as long as the educational institution recognizes the student as being within the first two years of his or her course of study. IRS Regulations Section 1.25A-3(d)(1)(iii) states that "credit given on the basis of the student's performance on proficiency examinations is to be disregarded" Since the educational institution issues a Form 1098-T that notifies the IRS of the student's qualification for the credit, I suggest watching the form issued by the school closely in the case of a student who has not been at school for two years, but has more than two years of credit because of examination credit. If appropriate, you can contact the school and ask them to amend the form so that your student will continue to qualify for the Hope credit.

The maximum Hope credit is \$1,500 per qualifying student, which you receive if you paid \$2,000 or more of tuition and related expenses required by the school as a condition of enrollment. You receive a dollar-for-dollar credit for the first \$1,000 of qualifying expenses, and a 50% credit for the second \$1,000. If you pay for more than one qualifying student that is your dependent, you can claim the Hope credit for each of them.

The Lifetime Learning Credit is available for more students, but in most cases is less generous than the Hope credit.

There is no degree, certificate, or work load requirement, and it is available for upper division and graduate level education. The maximum credit is \$2,000 per tax return, and is 20% of the first \$10,000 for tuition and related expenses for all eligible students on a tax return. If you pay for more than one student, including you, your spouse, and your dependents, the qualifying education expenses are added for all of them and the 20% credit is calculated on the total.

Both education credits are claimed in the year tuition payment is made. This can be a useful tax planning tool, especially involving the semester or quarter beginning in January. You often can choose to pay for that period at the end of December or the beginning of January, so get help if you need it to calculate the credit both ways to see which is better for you. It is also useful to note that if the tuition payment is made with borrowed money, the credit is claimed in the year the loan proceeds are used to pay the tuition, not the year the loan is repaid.

Like almost all tax credits, there are additional qualifying conditions. You cannot claim both a Hope and a Lifetime Learning Credit for the same student in the same year. If you are married, you must file a joint return with your spouse to claim either of the education credits. There are also income limitations. Phaseout of the credits begin at \$42,000 (\$85,000 if filing a joint return) of modified adjusted gross income (MAGI) and the credits are not available at all above \$52,000 MAGI (\$105,000 if filing jointly) for education expenses paid in 2004.

Education Tax Deductions and Exclusions

Three tax deduction/exclusion possibilities are available. These are the student loan interest deduction, the deduction for job-related education expenses, and the exclusion of U.S. Savings Bond interest income used to pay education expenses. This is followed by a description of Coverdell Education Savings Accounts. You usually have to choose between claiming a deduction or one of the credits discussed earlier in this article, so it is important to calculate the benefit of both and see which is best for you. In some cases, you can claim more expenses using a deduction than you can with a credit, and sometimes the combination of state and federal tax rates can make the benefit of the deduction larger than a credit, even if the allowed expenses are identical. In other cases, the credit gives the larger benefit. This can vary from one year to the next, so be sure to do the calculation each year.

The Student Loan Interest Deduction. Up to \$2,500 of student loan interest can be deducted from gross income, based on the following qualifying restrictions:

- ✓ You cannot claim the deduction in the current year if you are claimed as a dependent by another person or if you are married and file a separate tax return.
- ✓ The deduction is phased out beginning at \$50,000 modified adjusted gross income (MAGI) (\$100,000 if filing a joint return). It is not available at all above \$65,000 MAGI (\$130,000 if filing a joint return).

- ✓ Interest on student loans from relatives is not eligible for the deduction.
- ✓ You must use the loan proceeds only to pay qualified education expenses for yourself, your spouse, or your dependents claimed on your tax return.
- ✓ If the loan is based on home equity, you can claim the interest as a mortgage interest deduction or a student loan interest deduction, but not both.

Job-related continuing education expenses can be claimed as an itemized deduction subject to these rules:

- ✓ The education must improve your skills at your current employment, and cannot qualify you for another line of work. For example, a business law course may improve your skills at your job, and would thus qualify. However, the same course as part of a program to receive a law degree would not be deductible if it qualified you for a new career as an attorney, even if you have no intention to change careers.
- ✓ You cannot claim both an education tax credit and a deduction for the same expense.
- ✓ As a job-related expense, you can deduct car mileage or other travel to get to and from the classes, as well as meals and lodging if you must travel away from home overnight to attend. This is in addition to tuition, books, and other associated fees and supplies. Since this rule is more generous than what is allowed for the education credits, it may have an impact on your choice of credit or deduction.
- ✓ You add these expenses to other job-related expenses and miscellaneous itemized deductions, and then subtract 2% of adjusted gross income. The difference is your usable deduction.

I suggest asking your employer to reimburse you upon the successful completion of these job-related courses, rather than paying them yourself and claiming this deduction. Both you and your employer would be better off, since your employer can claim the full deduction without the 2% of income limitation. In addition, payroll taxes such as social security, medicare, and unemployment (not to mention workers compensation) are due on the wages you use to pay for job related education expenses. If your employer reimburses you instead, this reimbursement is not considered wages and so are not subject to these payroll taxes.

Exclusion of U.S. Savings Bond Interest Used To Pay Education Costs. If your modified adjusted gross income is below \$59,850 (\$89,750 if married filing a joint return) you can exclude all U.S. Savings Bond interest used to pay education costs from your tax return. Above these income levels, the exclusion is gradually phased out until at \$74,850 it is not available at all (\$119,750 if married filing a joint return). Once again, if you are married you cannot file a separate tax return from your spouse and use this provision.

Coverdell Education Savings Accounts. These accounts are trusts created for the sole purpose of paying the qualified education expenses of a specific individual beneficiary. No deduction is allowed for contributions to these accounts. No contributions to the account can be made after the beneficiary reaches age 18 (except for an individual who requires additional time to complete his or her education because of a physical, mental, emotional, or learning disability condition. Total contributions to the account are limited to \$2,000 per year.

Earnings on the accounts are tax free, as are withdrawals used to pay qualified education expenses. Care must be taken not to take withdrawals for any other purpose, since they are subject to ordinary income tax plus an additional 10 percent tax! Generally, any balance remaining in the account must be distributed within 30 days after the beneficiary's 30th birthday, or after death if that occurs first. If this becomes a concern, a good option is to name a new beneficiary before this 30th birthday. If a contributor has income above \$95,000 (\$190,000 if married filing a joint return) then the amount that can be contributed to a Coverdell account is gradually reduced until it is eliminated at an income of \$110,000 (\$220,000 if married filing a joint return). It is useful to note that corporations and other entities, including tax-exempt organizations, are allowed to make contributions without any income limitations.

Important Note!

The information in this article is intended to inform you of some of the financial opportunities provided in the tax laws or elsewhere. It is not intended to give you specific advice for your personal situation. If you need such advice, please contact a qualified professional! Please call or e-mail me (doug@accuteksolutions.com) for an initial consultation to discuss your personal situation and how the tax laws might benefit you. Your first 30-minute visit is free to let you sample what we can do for you at no cost or obligation. We also invite you to submit questions you'd like to have answered in a future article!

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