

What Can Education Do for You?

Education is a life-long adventure. It doesn't matter if you're a student, a parent, a grandparent, or someone who has no children; we are all impacted in one way or another by education. It is the tax implications and opportunities of education that we want to address here. We hope you will find something of interest no matter what stage of life you are in.

Taxation

Employer-provided education benefits can cause your income to increase unless the employer pays for job-related education or has a nondiscriminatory educational benefit program that provides benefits of up to \$5,250. This benefit program may be used for undergraduate as well as graduate level education.

Scholarships are generally not taxable to the extent they are used to pay for tuition and books. Scholarship monies received to pay for living expenses including food and shelter are taxable. If your child receives this money, it is taxable to the child, not the parent. Forms are rarely sent disclosing the information; it is something you must monitor on your own.

If you perform services in exchange for the payment of educational expenses such as a work study program, you will receive a W-2. If the work is performed for the educational institution, it generally will not be subject to Social Security or Medicare tax.

Deductions

If you are paying tuition for yourself, your spouse, or your dependent, you may be able to claim a deduction for the tuition and related fees. This is a deduction which will reduce your income dollar for dollar up to \$4,000. The \$4,000 deduction is available to taxpayers with income before itemized deductions of \$160,000 (\$80,000 for single) or less. A smaller deduction of \$2,000 is available for income levels of \$130,000 (\$65,000 for single) or less. Time is running out

because this benefit will end on December 31, 2007 (under current law).

If you attend classes related to your occupation as an employee and pay for them out of your own pocket, the deduction is work related and is deductible as an employee business expense on Form 2106 (Employee Business Expenses). The deduction includes tuition; fees; books; lodging, if you are away from home overnight; meals during the overnight stays; and travel expenses such as mileage, airline tickets, or other means of travel. There are limitations that apply and not everyone will benefit by this deduction.

Credits

One of the best tax law changes for individuals and families alike was the creation of various education credits. Two different credits are available, the Hope Credit and the Lifetime Learning Credit.

The Hope Credit is available to the student who is a freshman or sophomore as of the first school day of the year. The credit is based on the tuition paid. Generally, the cost of books and room and board do not affect the credit. The credit is equal to 100% of the first \$1,100 of tuition plus 50% of the next \$1,100 of tuition for a maximum credit of \$1,650 per year. It generally results in a larger benefit than the Lifetime Learning Credit but has some limitations. The credit may generally only be taken in two tax years per qualifying student. The student must be at least a half-time student. He or she must be pursuing a degreed or certified program. It could be a

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four-year traditional degree or shorter certification program such as licensed nursing, cosmetology, or even truck driving. The student must not have been convicted of a drug-related felony. If the student is a dependent child, it is the parent claiming the exemption who will receive the benefit of the credit regardless of who paid for the tuition. This is a particularly important factor when divorced parents decide who will be paying the college tuition of their children. If one parent is paying the tuition but the dependent child is being claimed by the other parent, it is the parent who claims the child who will be eligible for the credit, not the one paying the tuition.

The Lifetime Learning Credit is available to anyone who is broadening his or her horizons through education that could improve current job skills or prepare for a new occupation. The credit is allowed whether you are taking one class or a full load. The credit is based on the tuition paid, just like the Hope Credit. The credit is equal to 20% of the tuition paid with a maximum credit of \$2,000. If you are pursuing a four-year degree, two years of the Hope Credit followed by an unlimited number of years

of the Lifetime Learning Credit will provide a little extra help in paying for the bills.

Both credits have an income limitation when qualifying for the credit. Classes must be taken at a qualified institution. Generally, any educational institution eligible to offer federal financial aid will qualify. When determining the credit, the tuition must be reduced by scholarships, GI bill, and other nontaxable grants.

Financial Aid

When a student finances education with money received through a financial aid package, it is important to know whether the money is a repayable loan or a grant. A grant will reduce the tuition eligible for the credit or deduction. A loan will not affect the educational tax benefits. However, the loan may cause a student not to qualify as a dependent. Under the new rules for qualifying child (i.e. dependent), a child cannot provide more than half of his own support. If Johnny is given a loan to cover the cost of tuition while attending a private college where the tuition is \$30,000 per year, he will be deemed to have spent \$30,000

toward his support if he is liable for the loan. Johnny's total support will need to be more than \$60,000 for the year if mom and dad are to claim Johnny as their dependent.

Investments

When you have young children, one of the questions you might consider is, "How can we pay for their education?" You might answer that question by putting money into a uniform transfer to minors account (UTMA). You may invite others to contribute to the account as well. You may contribute to a Roth IRA in your own name with the idea of invading the principal when it is college time. There are two other options you may want to consider: a 529 Education Savings Plan or a 530 Coverdell Education Savings Account. Both of these plans allow you to contribute money that will grow tax free if used for education. It is a great way to avoid paying taxes on the earnings accumulated for savings. There are many different ways to structure these accounts. You should talk to a financial advisor as well as a tax professional when you are ready to make these decisions. **EA**



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