FALL 2005

Client Newsletter

Educational Incentives

The beginning of the school year can bring a feeling of emptiness to a household when your child goes off to college. Remember that child you sent off to kindergarten 18 years ago and you thought college was a long way off? It's amazing how quickly that toddler grew into a young adult, graduated from high school, and left you with that empty nest.

So what does all of this have to do with your tax situation? In 1997, major changes occurred in the tax code to encourage post secondary school attendance by providing tax incentives. The Hope Scholarship and Lifetime Learning credits were created to provide those tax breaks.

The Hope Scholarship Credit is available to students who are in their freshman or sophomore year of post-secondary school. It is available only twice in the student's educational career even if your child's freshman or sophomore years total more than two. The credit is based on the tuition paid during the year, which is equal to 100% of the tuition up to $1,000 and 50% of the next $1,000 of tuition for a maximum credit of $1,500 per year per student. Tuition and certain related fees are the only education expenses used to calculate this credit. Even then, any tax-free scholarships or grants received by the student must first reduce the tuition paid before the calculation of the credit. Transportation, books, and living expenses are generally ignored for purposes of this credit. Other criteria must be met to claim this credit including at least half-time status in a degreed program. Your student also will not qualify for the credit if they have been convicted of a drug-related felony.

Another educational alternative is the Lifetime Learning Credit. This credit is calculated using the same type of educational expenses (i.e. tuition) but is limited to 20% of the tuition for a maximum credit of $2,000. Based on this, $10,000 of tuition will yield the maximum credit of $2,000. In calculating the credit, the tuition is reduced by scholarships and grants received by the student just like the Hope Scholarship Credit. The Lifetime Learning Credit, as you might expect from its name, applies for the lifetime of the student. It does not have a maximum time limit. It also does not require the student to be enrolled full-time in a degreed program. It applies to any classes that may train you or your student for a new job or enhance skills in the current job. Entertaining classes such as social dancing, archery, or basket weaving will not qualify unless the class is related to your specific occupation.

All of this may be more technical than you want to hear, but the important part is that you may be able to benefit from these credits as long as the child is your dependent and is under the age of 24. If you are a divorced parent, you must be claiming your child's exemption to qualify for the credit. Higher income levels may prohibit some people from taking advantage of the credit. Filing a separate return when you're married will prohibit you from qualifying for the credit. Your tax professional can advise you on your particular situation.

You will need to gather certain information in order to claim the credit. Your child should receive a document (Form 1098-T) from the educational institution he or she attends. This may show the amount of tuition that institution received (or charged) during the year. It may also show the scholarships received during the year. There may be some outside scholarships or GI Bill payments that are not included but that you will need to properly calculate the credit.

Don't forget that these credits are not limited to your children. If you or your spouse are attending school, you could qualify for these credits, too.

Educational incentives go beyond these credits. Certain higher income individuals will not be able to take advantage of these credits but may qualify for an above-the-line deduction. The deduction is based on the same type of expenses as the credits. The deduction is limited to $4,000 for some income levels and $2,000 for other levels. Also, if an educational expense is deductible under any other provision, it is not deductible as a qualified higher education expense. Unfortunately, 2005 will be the last year to take advantage of the above-the-line deduction, unless Congress extends this provision. The credits, on the other hand, do not have an expiration date.

If you or your child qualify for a scholarship, the scholarship will reduce the tuition used to qualify for the credits or deduction. But don't stop there. It is important to know how much scholarship was received and whether it was specifically earmarked for a certain purpose. If the scholarship was specifically designated for housing or the purchase of textbooks, it will not reduce tuition in calculating the credit. On the other hand, if the amount of the scholarship exceeds the cost of tuition and books, the excess will be taxable to the individual receiving the scholarship.

Financing the cost of post-secondary education often means taking loans to pay for education. The interest on educational loans may be deductible at the time the loans are repaid. The interest is an above-the-line deduction which means you need not itemize to benefit from the deduction. The interest deduction is limited to $2,500 per year per taxpayer. The deduction belongs to the taxpayer who is responsible for the debt. If the loan is in the child's name, the deduction will belong to the child. Mom and dad cannot claim a deduction for the interest they generously pay back for their child. However, mom and dad may have taken a loan in their names to pay for their child's education. As long as the child was their dependent at the time the loan was incurred, the parent's will be allowed the deduction.

If you or your child are attending school now or in the near future, being aware of the educational opportunities will better prepare you to take advantage of these tax savings.

If your child is too young to attend college, this may be the perfect time to start saving for college. Congress has created tax incentives for saving money through Coverdell Educational Savings accounts and Section 529 Savings Plans. These plans do not give you an immediate tax deduction but they provide a place for money to grow potentially tax-free. If the monies accumulated in these accounts are used to pay for tuition, books, and certain living costs, the earnings will not be taxable.

There are many opportunities available to help defray the cost of education. Be proactive. Learn what is available so that your money buys as much education as possible.