College Tax Strategy

Education Tax Incentives

Table Of Contents

Table Of Contents (continued)

Section 1

Introduction

There are many education tax incentives that may be available to you if you are saving for or paying education costs. Most of these benefits apply only to higher education.

Two of these education tax incentives are actual tax credits, which reduce the amount of your income tax on a dollar-for-dollar basis. These tax credits are the:

- American Opportunity Credit
- Lifetime Learning Credit

In addition to these tax credits, there are other types of tax incentives for education that will allow you to:

- Deduct student loan interest
- Deduct tuition and fees for education
- Establish a Coverdell Education Savings Account (ESA), which features tax-free earnings
- Establish a Qualified Tuition Program (529 Plan), which features tax-free earnings
- Take early distributions from any type of individual retirement arrangement (IRA) for education costs without paying the 10% additional tax on early distributions
- Cash in savings bonds for education costs without having to pay tax on the interest

The following guide will help you determine whether, or not, you qualify for these education tax incentives and how to claim the tax benefit.

Note: You generally cannot claim more than one of the benefits described in the lists above for the same qualifying education expense.

Section

2

American Opportunity Tax Credit

You may be able to claim an American Opportunity tax credit (formerly known as the Hope tax credit) of up to $2,500 per year for four years of qualified education expenses paid for each eligible student. This particular credit is partially refundable, which means that it can reduce your tax to zero, but if the credit is more than your tax the excess will refunded to you up to a maximum refund of $1,000.

You can only elect one of the two education tax credits (American Opportunity credit or the Lifetime Learning credit). For example, if you elect to take the American Opportunity tax credit for a child on your 2013 tax return, you cannot, for that same child, also claim the Lifetime Learning credit for 2013.

If you pay qualified education expenses for more than one student in the same year, you can choose to take credits on a per-student, per-year basis. This means that, for example, you can claim the American Opportunity credit for one student and the Lifetime Learning credit for another student in the same year.

Who Can Claim the Credit?

Generally, you can claim the American Opportunity tax credit if all three of the following requirements are met:

- You pay “qualified” education expenses of higher education.
- You pay the qualified education expenses for an eligible student.
- The eligible student is either, 1) you, 2) your spouse, or 3) a dependent for whom you claim an exemption on your tax return.

Note: If your claim the eligible student as a dependent on your tax return, then any qualified education expenses paid by the dependent, or by a third party for that dependent, are considered paid by you.

Who Cannot Claim the Credit?

You cannot claim the American Opportunity tax credit for 2013 if any of the following apply:

- Your filing status is married filing separately.
- You personally are listed as a dependent on another person's tax return (such as your parents').
- Your modified adjusted gross income (MAGI) is $80,000 or more ($180,000 or more in the case of a joint return).
- You (or your spouse) were a nonresident alien for any part of 2013 and the nonresident alien did not elect to be treated as a resident alien for tax purposes.
- You claim the lifetime learning credit or a tuition and fees deduction for the same student in 2013.

What Education Expenses Qualify?

For purposes of the credit, qualified education expenses are tuition, fees, course materials, and certain related expenses required for enrollment or attendance at an eligible educational institution. The institution is required to make this allocation and provide you with the amount you paid (or were billed) for qualified education expenses on Form 1098-T, Tuition Statement.

<u>Eligible Educational Institution</u>
An eligible educational institution is any college, university, vocational school, or other postsecondary educational institution eligible to participate in a student aid program administered by the U.S. Department of Education. It includes virtually all accredited public, nonprofit, and proprietary (privately owned profit-making) postsecondary institutions.

<u>Related Expenses</u>
Student-activity fees and expenses for course-related books, supplies, and equipment are included in qualified education expenses only if the fees and expenses must be paid to the institution as a condition of enrollment or attendance.

<u>Academic Period</u>
Generally, the credit is allowed for qualified education expenses paid in 2013 for an academic period beginning in 2013 or in the first 3 months of 2014.

> **Example**: If you paid $1,500 in December 2013 for qualified tuition for the spring 2014 semester beginning in January 2014, you may be able to use that $1,500 in figuring your 2013 credit. An academic period includes a semester, trimester, quarter, or other period of study (such as a summer school session) as reasonably determined by an educational institution. In the case of an educational institution that uses credit hours or clock hours and does not have academic terms, each payment period can be treated as an academic period.

Expenses Paid With Borrowed Funds
You can claim a credit for qualified education expenses paid with the proceeds of a loan. Use the expenses to figure the credit for the year in which the expenses are paid, not the year in which the loan is repaid. Treat loan payments sent directly to the educational institution as paid on the date the institution credits the student's account.

No Double Benefit Allowed

You cannot do any of the following:

- Deduct higher education expenses on your income tax return (as, for example, a business expense) and also claim an American Opportunity credit based on those same expenses.
- Claim an American Opportunity credit in the same year that you are claiming a tuition and fees deduction for the same student.
- Claim an American Opportunity credit and a lifetime learning credit based on the same qualified education expenses.
- Claim an American Opportunity credit based on the same expenses used to figure the tax-free portion of a distribution from a Coverdell education savings account (ESA) or qualified tuition program (QTP).
- Claim a American Opportunity tax credit based on qualified education expenses paid with a tax-free scholarship, grant, or employer-provided educational assistance.

Adjustments to Qualified Education Expenses

If you pay qualified education expenses with certain tax-free funds, you cannot claim a credit for those amounts. You must reduce the qualified education expenses by the amount of any tax-free educational assistance and refund(s) you received tax-free educational assistance. This includes:

- The tax-free parts of scholarships and fellowships
- Pell grants
- Employer-provided educational assistance
- Veterans' educational assistance, and
- Any other nontaxable (tax-free) payments (other than gifts or inheritances) received as educational assistance.

Qualified education expenses do not include expenses for which you, or someone else who paid qualified education expenses on behalf of a student, receive a refund.

Expenses That Do Not Qualify

Qualified education expenses do not include amounts paid for:

- Insurance,
- Medical expenses (including student health fees),
- Room and board
- Transportation, or
- Similar personal, living, or family expenses.

This is true even if the amount must be paid to the institution as a condition of enrollment or attendance.

Who Is an Eligible Student?

To claim the American Opportunity credit, the student for whom you pay qualified education expenses must be an eligible student. This is a student who meets all of the following requirements:

- The student had not completed the first 4 years of postsecondary education before 2013.

- For at least one academic period beginning in 2013, the student was enrolled at least half-time in a program leading to a degree, certificate, or other recognized educational credential.

- The student has not been convicted of any federal or state felony for possessing or distributing a controlled substance as of the end of 2013.

Who Can Claim a Dependent's Expenses?

If there are qualified education expenses for your dependent for a year, either you or your dependent, but not both of you, can claim an American Opportunity credit for your dependent's expenses for that year.

1. If you claim an exemption on your tax return for a dependent who is an eligible student, then only you can claim the credit based on that dependent's expenses. The dependent cannot claim the credit.

2. If you do not claim an exemption on your tax return for a dependent who is an eligible student (even if entitled to the exemption), then only the dependent can claim the credit. You cannot claim the credit based on this dependent's expenses.

Again, if your claim the eligible student as a dependent on your tax return, then any qualified education expenses paid by the dependent, or by a third party for that dependent, are considered paid by you.

Figuring the Credit

The amount of the American Opportunity tax credit is the sum of:

1. 100% of the first $2,000 of qualified education expenses you paid for the eligible student, and

2. 25% of the next $2,000.

The maximum amount of American Opportunity tax credit you can claim $2,500. You can claim the full $2,500 for each eligible student for whom you paid at least $4,000 of qualified education expenses. However, the credit may be reduced based on your modified adjusted gross income (MAGI).

> **Example**: Jon and Karen Frost are married and file a joint tax return. For 2013, they claim an exemption for their dependent daughter on their tax return. Their MAGI is $160,000. Their daughter is in her sophomore (second) year of studies at the local university. Jon and Karen paid qualified education expenses of $4,300 in 2013. Jon and Karen, their daughter, and the local university meet all of the requirements for the American Opportunity tax credit. Jon and Karen can claim a $2,500 credit in 2013.

Form 1098-T

To help you figure your American Opportunity tax credit, you should receive Form 1098-T. Generally, an eligible educational institution (such as a college or university) must send Form 1098-T (or acceptable substitute) to each enrolled student by February 2, 2014. An institution may choose to report either payments received (box 1), or amounts billed (box 2), for qualified education expenses. However, the amounts in boxes 1 and 2 of Form 1098-T may be different than what you actually paid. When figuring the credit, use only the amounts you paid or were deemed to have paid in 2013 for qualified education expenses.

In addition, your Form 1098-T should give you other information from that institution, such as adjustments made for prior years, the amount of scholarships or grants, reimbursements or refunds, and whether you were enrolled at least half-time or were a graduate student.

The eligible educational institution may ask for a completed Form W-9S, Request for Student's or Borrower's Taxpayer Identification Number and

Certification, or similar statement to obtain the student's name, address, and taxpayer identification number.

Income Phaseout vs. Amount of Your Credit

The amount of your American Opportunity tax credit is phased out (gradually reduced) if your modified adjusted gross income (MAGI) is between $80,000 and $90,000 ($160,000 and $180,000 if you file a joint return). You cannot claim a credit if your MAGI is $90,000 or more ($180,000 or more if you file a joint return).

For most taxpayers, MAGI is adjusted gross income (AGI) as figured on their federal income tax return. If your MAGI is within the range of incomes where the credit must be reduced, you will figure your reduced credit using lines 7–13 of Form 8863.

How To Claim the Credit?

You claim the American Opportunity tax credit by completing Parts I and III of Form 8863 and submitting it with your Form 1040 or 1040A. Enter the credit on Form 1040, line 50, or on Form 1040A, line 31.

> **Planning tip**: As a tax planning strategy, families who have Modified AGI in excess of the phase out levels may not want to claim the student as a dependent. The student can claim the credit, provided the student's Modified AGI is not above the phase out limits. Nonetheless, by not being claimed on the parents' tax return, a student is not "independent" of the parents under the financial aid rules. The parents' income and assets will still have to be listed on the student's financial aid application; this tax planning strategy will not increase the student's financial aid eligibility.
>
> **Planning tip**: By prepaying or delaying the payment of qualified expenses, the taxpayer may effectively choose the year in which to claim the credit. Also, the taxpayer can use this type of planning to insure that the maximum credit of $2,500 per year is reached.
>
> **Planning tip**: A taxpayer who qualifies for the credit this year but won't next year because AGI will exceed the phase-out limits should consider prepaying tuition for the winter term. This will maximize the credit.

Documents Used To Claim The Credit

These are the documents you will need to implement the American Opportunity tax credit:

- Form 1098-T
- Form 8863

IRS Publications & Forms References

IRS Publications

Tax Benefits For Education
Publication 970: Tax Benefits For Education
http://www.irs.gov/pub/irs-pdf/p970.pdf

Section

3

Lifetime Learning Tax Credit

You may be able to claim a lifetime learning tax credit of up to $2,000 for qualified education expenses paid for all students enrolled in eligible educational institutions. There is no limit on the number of years the lifetime learning credit can be claimed for each student.

For each student, you can elect for any year only one of the credits. For example, if you elect to take the lifetime learning credit for a child on your 2013 tax return, you cannot, for that same child, also claim the a American Opportunity (Hope) credit for 2013.

If you pay qualified education expenses for more than one student in the same year, you can choose to take credits on a per-student, per-year basis. This means that, for example, you can claim the lifetime learning credit for one student and the lifetime learning credit for another student in the same year.

Who Can Claim the Credit?

Generally, you can claim the lifetime learning tax credit if all three of the following requirements are met:

- You pay “qualified” education expenses of higher education.
- You pay the qualified education expenses for an eligible student.
- The eligible student is either, 1) you, 2) your spouse, or 3) a dependent for whom you claim an exemption on your tax return.

Note: If your claim the eligible student as a dependent on your tax return, then any qualified education expenses paid by the dependent, or by a third party for that dependent, are considered paid by you.

Who Cannot Claim the Credit?

You cannot claim the credit for 2013 if any of the following apply:

- Your filing status is married filing separately.
- You personally are listed as a dependent on another person's tax return (such as your parents').

- Your modified adjusted gross income (MAGI) is $62,000 or more ($124,000 or more in the case of a joint return).
- You (or your spouse) were a nonresident alien for any part of 2013 and the nonresident alien did not elect to be treated as a resident alien for tax purposes.
- You claim the American Opportunity tax credit or a tuition and fees deduction for the same student in 2013.

What Education Expenses Qualify?

For purposes of the credit, qualified education expenses are tuition, fees, course materials, and certain related expenses required for enrollment or attendance at an eligible educational institution. The institution is required to make this allocation and provide you with the amount you paid (or were billed) for qualified education expenses on Form 1098-T, Tuition Statement.

Eligible Educational Institution
An eligible educational institution is any college, university, vocational school, or other postsecondary educational institution eligible to participate in a student aid program administered by the U.S. Department of Education. It includes virtually all accredited public, nonprofit, and proprietary (privately owned profit-making) postsecondary institutions.

Related Expenses
Student-activity fees and expenses for course-related books, supplies, and equipment are included in qualified education expenses only if the fees and expenses must be paid to the institution as a condition of enrollment or attendance.

Academic Period
Generally, the credit is allowed for qualified education expenses paid in 2013 for an academic period beginning in 2013 or in the first 3 months of 2014.

> **Example**: If you paid $1,500 in December 2013 for qualified tuition for the spring 2014 semester beginning in January 2014, you may be able to use that $1,500 in figuring your 2013 credit. An academic period includes a semester, trimester, quarter, or other period of study (such as a summer school session) as reasonably determined by an educational institution. In the case of an educational institution that uses credit hours or clock hours and does not have academic terms, each payment period can be treated as an academic period.

Expenses Paid With Borrowed Funds
You can claim a credit for qualified education expenses paid with the proceeds of a loan. Use the expenses to figure the credit for the year in which the expenses are paid, not the year in which the loan is repaid. Treat loan

payments sent directly to the educational institution as paid on the date the institution credits the student's account.

No Double Benefit Allowed

You cannot do any of the following:

- Deduct higher education expenses on your income tax return (as, for example, a business expense) and also claim a lifetime learning tax credit based on those same expenses.

- Claim a lifetime learning tax credit in the same year that you are claiming a tuition and fees deduction for the same student.

- Claim a lifetime learning tax credit and a American Opportunity tax credit based on the same qualified education expenses.

- Claim a lifetime learning tax credit based on the same expenses used to figure the tax-free portion of a distribution from a Coverdell education savings account (ESA) or qualified tuition program (QTP).

- Claim a lifetime learning tax credit based on qualified education expenses paid with a tax-free scholarship, grant, or employer-provided educational assistance.

Adjustments to Qualified Education Expenses

If you pay qualified education expenses with certain tax-free funds, you cannot claim a lifetime learning tax credit for those amounts. You must reduce the qualified education expenses by the amount of any tax-free educational assistance and refund(s) you received tax-free educational assistance. This includes:

- The tax-free parts of scholarships and fellowships
- Pell grants
- Employer-provided educational assistance
- Veterans' educational assistance, and
- Any other nontaxable (tax-free) payments (other than gifts or inheritances) received as educational assistance.

Qualified education expenses do not include expenses for which you, or someone else who paid qualified education expenses on behalf of a student, receive a refund.

Expenses That Do Not Qualify

Qualified education expenses do not include amounts paid for:

- Insurance,
- Medical expenses (including student health fees),
- Room and board
- Transportation, or
- Similar personal, living, or family expenses.

This is true even if the amount must be paid to the institution as a condition of enrollment or attendance.

Who Is an Eligible Student?

To claim the lifetime learning tax credit, the student for whom you pay qualified education expenses must be an eligible student. This is a student who meets all of the following requirements:

- The student had not completed the first 4 years of postsecondary education before 2013.

- For at least one academic period beginning in 2013, the student was enrolled at least half-time in a program leading to a degree, certificate, or other recognized educational credential.

- The student has not been convicted of any federal or state felony for possessing or distributing a controlled substance as of the end of 2013.

Who Can Claim a Dependent's Expenses?

If there are qualified education expenses for your dependent for a year, either you or your dependent, but not both of you, can claim a lifetime learning tax credit for your dependent's expenses for that year.

3. If you claim an exemption on your tax return for a dependent who is an eligible student, then only you can claim the credit based on that dependent's expenses. The dependent cannot claim the credit.

4. If you do not claim an exemption on your tax return for a dependent who is an eligible student (even if entitled to the exemption), then only the dependent can claim the credit. You cannot claim the credit based on this dependent's expenses.

Again, if your claim the eligible student as a dependent on your tax return, then any qualified education expenses paid by the dependent, or by a third party for that dependent, are considered paid by you.

Figuring the Credit

The amount of the lifetime learning credit is 20% of the first $10,000 of qualified education expenses you paid for all eligible students.

The maximum amount of lifetime learning credit you can claim for 2013 is $2,000 (20% × $10,000). However, that amount may be reduced based on your modified adjusted gross income (MAGI).

> **Example:** You are filing a joint return with a MAGI of $104,000. In 2013, you paid $6,600 of qualified education expenses. You figure the tentative lifetime learning credit (20% of the first $10,000 of qualified education expenses you paid for all eligible students). The result is a $1,320 (20% x $6,600) tentative credit.

Form 1098-T

To help you figure your credit, you should receive Form 1098-T. Generally, an eligible educational institution (such as a college or university) must send Form 1098-T (or acceptable substitute) to each enrolled student by February 2, 2014. An institution may choose to report either payments received (box 1), or amounts billed (box 2), for qualified education expenses. However, the amounts in boxes 1 and 2 of Form 1098-T may be different than what you actually paid. When figuring the credit, use only the amounts you paid or were deemed to have paid in 2013 for qualified education expenses.

In addition, your Form 1098-T should give you other information from that institution, such as adjustments made for prior years, the amount of scholarships or grants, reimbursements or refunds, and whether you were enrolled at least half-time or were a graduate student.

The eligible educational institution may ask for a completed Form W-9S, Request for Student's or Borrower's Taxpayer Identification Number and Certification, or similar statement to obtain the student's name, address, and taxpayer identification number.

Income Phaseout vs. Amount of Your Credit

The amount of your lifetime learning tax credit is phased out (gradually reduced) if your modified adjusted gross income (MAGI) is between $52,000 and $62,000 ($104,000 and $124,000 if you file a joint return). You cannot claim a credit if your MAGI is $62,000 or more ($124,000 or more if you file a joint return).

For most taxpayers, MAGI is adjusted gross income (AGI) as figured on their federal income tax return. If your MAGI is within the range of incomes where the credit must be reduced, you will figure your reduced credit using lines 7–13 of Form 8863.

How To Claim the Credit?

You claim the lifetime learning tax credit by completing Parts I and III of Form 8863 and submitting it with your Form 1040 or 1040A. Enter the credit on Form 1040, line 50, or on Form 1040A, line 31.

Planning tip: As a tax planning strategy, families who have Modified AGI in excess of the phase out levels may not want to claim the student as a dependent. The student can claim the credit, provided the student's Modified AGI is not above the phase out limits. Nonetheless, by not being claimed on the parents' tax return, a student is not "independent" of the parents under the financial aid rules. The parents' income and assets will still have to be listed on the student's financial aid application; this tax planning strategy will not increase the student's financial aid eligibility.

Planning tip: By prepaying or delaying the payment of qualified expenses, the taxpayer may effectively choose the year in which to claim the credit. Also, the taxpayer can use this type of planning to insure that the maximum credit of $2,000 per year is reached.

Planning tip: A taxpayer who qualifies for the credit this year but won't next year because AGI will exceed the phase-out limits should consider prepaying tuition for the winter term. This will maximize the credit.

Documents Used To Claim The Credit

These are the documents you will need to implement the Lifetime Learning tax credit:

- Form 1098-T
- Form 8863

IRS Publications & Forms References

IRS Publications

Tax Benefits For Education
Publication 970: Tax Benefits For Education
http://www.irs.gov/pub/irs-pdf/p970.pdf

Section

4

Student Loan Interest Deduction

You can deduct the loan interest that you paid during the year on a qualified student loan. The student loan interest deduction is taken as an adjustment to income. This means you can claim this deduction even if you do not itemize deductions on Schedule A (Form 1040).

Who Can Deduct Student Loan Interest?

Generally, you can claim the deduction if all of the following requirements are met:

- Your filing status is any filing status except married filing separately.
- No one else is claiming an exemption for you on his or her tax return.
- You are legally obligated to pay interest on a qualified student loan.
- You paid interest on a qualified student loan.

Claiming An Exemption For You
Another taxpayer is claiming an exemption for you if he or she lists your name and other required information on his or her Form 1040 (or Form 1040A), line 6c.

Interest Paid By Others
If you are the person legally obligated to make interest payments and someone else makes a payment of interest on your behalf, you are treated as receiving the payments from the other person and, in turn, paying the interest.

What Education Expenses Qualify?

For purposes of the student loan interest deduction, these expenses are the total costs of attending an eligible educational institution, including graduate school. They include amounts paid for the following items.

- Tuition and fees:
- Room and board
- Books, supplies, and equipment
- Other necessary expenses (such as transportation)

The cost of room and board qualifies only to the extent that it is not more than the greater of:

- The allowance for room and board, as determined by the eligible educational institution, that was included in the cost of attendance (for federal financial aid purposes) for a particular academic period and living arrangement of the student, or

- The actual amount charged if the student is residing in housing owned or operated by the eligible educational institution.

Eligible Educational Institution
An eligible educational institution is any college, university, vocational school, or other postsecondary educational institution eligible to participate in a student aid program administered by the U.S. Department of Education. It includes virtually all accredited public, nonprofit, and proprietary (privately owned profit-making) postsecondary institutions.

For purposes of the student loan interest deduction, an eligible educational institution also includes an institution conducting an internship or residency program leading to a degree or certificate from an institution of higher education, a hospital, or a health care facility that offers postgraduate training.

Academic Period
An academic period includes a semester, trimester, quarter, or other period of study (such as a summer school session) as reasonably determined by an educational institution. In the case of an educational institution that uses credit hours or clock hours and does not have academic terms, each payment period can be treated as an academic period.

No Double Benefit Allowed

You cannot deduct as interest on a student loan any amount that is an allowable deduction under any other provision of the tax law (for example, as home mortgage interest). You also cannot deduct interest on a loan made under a qualified employer plan or under a contract purchased under such a plan.

Adjustments to Qualified Education Expenses

You must reduce your qualified education expenses by the total amount paid for them with the following tax-free items:

- Employer-provided educational assistance
- Tax-free distribution of earnings from a Coverdell education savings account (ESA)

- Tax-free distribution of earnings from a qualified tuition program (QTP)
- U.S. savings bond interest that you exclude from income because it is used to pay qualified education expenses
- The tax-free part of scholarships and fellowships
- Veterans' educational assistance
- Any other nontaxable (tax-free) payments (other than gifts or inheritances) received as educational assistance

Who Is an Eligible Student?

An eligible student is one who is enrolled at least half-time in a program leading to a degree, certificate, or other recognized educational credential. A student is considered to be enrolled at least half-time if the student is taking at least half the normal full-time work load for his or her course of study.

The standard for what is half of the normal full-time work load is determined by each eligible educational institution. However, the standard may not be lower than any of those established by the U.S. Department of Education under the Higher Education Act of 1965.

Related persons
You cannot deduct interest on a loan you get from a related person. Related persons include:

- Your spouse,
- Your brothers and sisters,
- Your half brothers and half sisters,
- Your ancestors (parents, grandparents, etc.),
- Your lineal descendants (children, grandchildren, etc.), and
- Certain corporations, partnerships, trusts, and exempt organizations.

What Is A Qualified Student Loan?

A Qualified Student Loan is a loan that you take out solely to pay qualified education expenses that were:

- For you, your spouse, or a person who was your dependent when you took out the loan,
- Paid or incurred within a reasonable period of time before or after you took out the loan, and
- For education provided during an academic period for an eligible student.

Loans from the following sources are not qualified student loans:

- A related person

- A qualified employer plan

Generally, your dependent is someone who is either a:

- Qualifying child, or
- Qualifying relative.

Dependent Exceptions

For purposes of the student loan interest deduction, there are the following exceptions to the general rules for dependents:

- An individual can be your dependent even if you are the dependent of another taxpayer
- An individual can be your dependent even if the individual files a joint return with a spouse
- An individual can be your dependent even if the individual had gross income that was equal to or more than the exemption amount for the year ($3,900 for 2013)

What Is Included As Loan Interest?

In addition to simple interest on the loan, if all other requirements are met, the items discussed below can be student loan interest.

<u>Loan Origination Fees</u>
In general, this is a one-time fee charged by the lender when a loan is made. To be deductible as interest, a loan origination fee must be for the use of money rather than for property or services (such as commitment fees or processing costs) provided by the lender. A loan origination fee treated as interest accrues over the term of the loan.

Loan origination fees were not required to be reported on Form 1098-E, Student Loan Interest Statement, for loans made before September 1, 2004. If loan origination fees are not included in the amount reported on your Form 1098-E, you can use any reasonable method to allocate the loan origination fees over the term of the loan. The method shown in the example below allocates equal portions of the loan origination fee to each payment required under the terms of the loan. A method that results in the double deduction of the same portion of a loan origination fee would not be reasonable.

> **Example**: In August 2004, Bill took out a student loan for $16,000 to pay the tuition for his senior year of college. The lender charged a 3% loan origination fee ($480) that was withheld from the funds Bill received. Bill began making payments on his student loan in 2008. Because the loan origination fee was not included in his 2008 Form 1098-E, Bill can use any reasonable method to allocate that fee over

the term of the loan. Bill's loan is payable in 120 equal monthly payments. He allocates the $480 fee equally over the total number of payments ($480 ÷ 120 months = $4 per month). Bill made 7 payments in 2008, so he paid $28 ($4 × 7) of interest attributable to the loan origination fee. To determine his student loan interest deduction, he will add the $28 to the amount of other interest reported to him on Form 1098-E.

Capitalized Interest
This is unpaid interest on a student loan that is added by the lender to the outstanding principal balance of the loan. Capitalized interest is treated as interest for tax purposes and is deductible as payments of principal are made on the loan. No deduction for capitalized interest is allowed in a year in which no loan payments were made.

Interest On Revolving Lines Of Credit
This interest, which includes interest on credit card debt, is student loan interest if the borrower uses the line of credit (credit card) only to pay qualified education expenses.

Interest On Refinanced Student Loans
This includes interest on both:

- Consolidated loans – loans used to refinance more than one student loan of the same borrower, and
- Collapsed loans – two or more loans of the same borrower that are treated by both the lender and the borrower as one loan.

If you refinance a qualified student loan for more than your original loan and you use the additional amount for any purpose other than qualified education expenses, you cannot deduct any interest paid on the refinanced loan.

Voluntary Interest Payments
These are payments made on a qualified student loan during a period when interest payments are not required, such as when the borrower has been granted a deferment or the loan has not yet entered repayment status.

What Is Not Included As Loan Interest?

You cannot claim a student loan interest deduction for any of the following items:

- Interest you paid on a loan if, under the terms of the loan, you are not legally obligated to make interest payments.

- Loan origination fees that are payments for property or services provided by the lender, such as commitment fees or processing costs.

- Interest you paid on a loan to the extent payments were made through your participation in the National Health Service Corps Loan Repayment Program (the "NHSC Loan Repayment Program") or certain other loan repayment assistance programs.

When Must Loan Interest Be Paid?

You can deduct all interest you paid during the year on your student loan, including voluntary payments, until the loan is paid off.

<u>Reasonable period of time</u>
Qualified education expenses are treated as paid or incurred within a reasonable period of time before or after you take out the loan if they are paid with the proceeds of student loans that are part of a federal postsecondary education loan program.

Even if not paid with the proceeds of that type of loan, the expenses are treated as paid or incurred within a reasonable period of time if both of the following requirements are met:

- The expenses relate to a specific academic period, and
- The loan proceeds are disbursed within a period that begins 90 days before the start of that academic period and ends 90 days after the end of that academic period.

If neither of the above situations applies, the reasonable period of time usually is determined based on all the relevant facts and circumstances.

Figuring the Interest Deduction

Your student loan interest deduction for 2013 is generally the smaller of:

- $2,500, or
- The interest you paid in 2013.

However, the amount determined above may be gradually reduced (phased out) or eliminated based on your filing status and modified adjusted gross income (MAGI) as explained below.

Form 1098-E

To help you figure your student loan interest deduction, you should receive Form 1098-E. Generally, an institution (such as a bank or governmental agency) that received interest payments of $600 or more during 2013 on one or more qualified student loans must send Form 1098-E (or acceptable substitute) to each borrower by February 2, 2014.

For qualified student loans taken out before September 1, 2004, the institution is required to include on Form 1098-E only payments of stated interest. Other interest payments, such as certain loan origination fees and capitalized interest, may not appear on the form you receive. However, if you pay qualifying interest that is not included on Form 1098-E, you can also deduct those amounts.

The lender may ask for a completed Form W-9S, Request for Student's or Borrower's Taxpayer Identification Number and Certification, or similar statement to obtain the borrower's name, address, and taxpayer identification number. The form may also be used by the borrower to certify that the student loan was incurred solely to pay for qualified education expenses.

Income Phaseout vs. Amount of Deduction

The amount of your student loan interest deduction is phased out (gradually reduced) if your modified adjusted gross income (MAGI) is between $60,000 and $75,000 ($125,000 and $155,000 if you file a joint return). You cannot take a student loan interest deduction if your MAGI is $75,000 or more ($150,000 or more if you file a joint return).

How To Deduct Student Loan Interest

To claim Student Loan Interest Deduction, enter the amount shown on Form 1098-E that you received from your banking institution on IRS Schedule 1040, line 33 or line 18 of Schedule 1040A.

> **Planning tip**: As a tax planning strategy, families who have Modified AGI in excess of the phase-out levels and do not qualify for financial aid may have the student take out "Unsubsidized Federal Stafford Loans" during college years. The student can take out these loans even though the student does not qualify for financial aid. The interest on these loans can be accrued and paid after the student leaves college. At that time, the student will be able to file a tax return and claim an exemption for the student and will probably be under the income phase-out levels. The student can then deduct the interest on the student's tax return; the maximum deduction at that time could be $2,500 per year.
>
> **Planning tip**: Students who have Unsubsidized Stafford Loans or other educational loans with accruing interest on the principal balance when the student completes school should consider the following:

- The accrued interest that is added to the original loan amount will be nondeductible as student loan interest to the taxpayer, and will become part of the principal balance of the loan if the student does not pay that interest before they finish school. If the student does pay the accrued interest on the educational loan before they finish school, the interest is then deductible to the taxpayer as student loan interest.

Planning tip: Some taxpayers may want to take out a home equity loan on their personal residence and use the proceeds to pay for qualified education expenses. However, the interest expense on this home equity loan must be deducted on Schedule A instead of on page one of the Form 1040. If the student will be attending a college that does not assess the personal residence, it probably is more beneficial for the taxpayer to take out a PLUS loan, rather than a personal residence equity loan, in order to pay for the college costs. The interest would be deductible in arriving at AGI (subject to the maximum deduction limits) rather than as an itemized deduction, which may be of no benefit if the taxpayer uses the standard deduction.

Planning tip: As a financial planning strategy, the parents may "certify," using IRS Form W-9S, to treat any debt that is secured by a qualified residence as not so secured. This "certification" allows the taxpayer to deduct the interest on the personal residence as student loan interest and in addition, reduce the value of an assessable asset (the personal residence).

Planning tip: Interest paid on any loan, not just the federal student loans, qualifies for the student loan interest deduction as long as the loan proceeds were used to pay for college expenses.

> **Example**: In August, Ron borrows $9,000 from a local bank for the purpose of paying his tuition and board for the fall semester at Minnesota University. Ron, an avid traveler, deposits the loan proceeds in his personal checking account, and immediately expends the funds on a world vacation.
>
> In September, Ron starts school, and arranges a monthly payment plan for his tuition and board with the university. Ron covers these monthly payments to the school through part-time work.
>
> Because the loan proceeds were disbursed within the time frame described in the regulations, Ron will be able to deduct the interest expense on the student loan, assuming the other requirements are met.

Documents Used To Claim The Deduction

These are the documents you will need to implement the Student Loan Interest Deduction:

- Form 1098-E

IRS Publications & Forms References

IRS Publications

Tax Benefits For Education
Publication 970: Tax Benefits For Education
http://www.irs.gov/pub/irs-pdf/p970.pdf

Section

5

Tuition & Fees Deduction

The tuition and fees deduction can reduce the amount of your income subject to tax by up to $4,000. You may be able to take the Hope or lifetime learning credit for your education expenses instead of a tuition and fees deduction. You can choose the one that will give you the lower tax.

This deduction is taken as an adjustment to income. This means you can claim this deduction even if you do not itemize deductions on Schedule A (Form 1040). This deduction may be beneficial to you if you cannot take either the American Opportunity credit or lifetime learning credit because your income is too high.

You may be able to deduct qualified education expenses paid during the year for yourself, your spouse, or your dependent. You cannot claim this deduction if your filing status is married filing separately or if another person can claim an exemption for you as a dependent on his or her tax return. The qualified expenses must be for higher education.

Who Can Claim the Deduction?

Generally, you can claim the tuition and fees deduction if all three of the following requirements are met:

- You pay qualified education expenses of higher education.
- You pay the education expenses for an eligible student.
- The eligible student is yourself, your spouse, or your dependent for whom you claim an exemption on your tax return.

Who Cannot Claim the Deduction?

You cannot claim the tuition and fees deduction if any of the following apply:

- Your filing status is married filing separately.
- Another person can claim an exemption for you as a dependent on his or her tax return. You cannot take the deduction even if the other person does not actually claim that exemption.

- Your modified adjusted gross income (MAGI) is more than $80,000 ($160,000 if filing a joint return).
- You were a nonresident alien for any part of the year and did not elect to be treated as a resident alien for tax purposes.
- You or anyone else claims a Hope or lifetime learning credit in 2013 with respect to expenses of the student for whom the qualified education expenses were paid.

What Expenses Qualify?

The tuition and fees deduction is based on qualified education expenses you pay for yourself, your spouse, or your dependent for whom you claim an exemption on your tax return. Generally, the deduction is allowed for qualified education expenses paid in 2013 in connection with enrollment at an institution of higher education during 2013 or for an academic period beginning in 2013 or in the first 3 months of 2014.

> **Example**: If you paid $1,500 in December 2013 for qualified tuition for the Spring 2014 semester beginning in January 2014, you may be able to use that $1,500 in figuring your 2013 deduction.

Eligible Educational Institution
An eligible educational institution is any college, university, vocational school, or other postsecondary educational institution eligible to participate in a student aid program administered by the U.S. Department of Education. It includes virtually all accredited public, nonprofit, and proprietary (privately owned profit-making) postsecondary institutions. The educational institution should be able to tell you if it is an eligible educational institution.

Related Expenses
Student-activity fees and expenses for course-related books, supplies, and equipment are included in qualified education expenses only if the fees and expenses must be paid to the institution as a condition of enrollment or attendance.

Academic Period
An academic period includes a semester, trimester, quarter, or other period of study (such as a summer school session) as reasonably determined by an educational institution. In the case of an educational institution that uses credit hours or clock hours and does not have academic terms, each payment period can be treated as an academic period.

Paid With Borrowed Funds
You can claim a tuition and fees deduction for qualified education expenses paid with the proceeds of a loan. You use the expenses to figure the deduction for the year in which the expenses are paid, not the year in which the loan is

repaid. Treat loan payments sent directly to the educational institution as paid on the date the institution credits the student's account.

No Double Benefit Allowed

You cannot do any of the following:

- Deduct qualified education expenses you deduct under any other provision of the law, for example, as a business expense.
- Deduct qualified education expenses for a student on your income tax return if you or anyone else claims a Hope or lifetime learning credit for that same student in the same year.
- Deduct qualified education expenses that have been used to figure the tax-free portion of a distribution from a Coverdell education savings account (ESA) or a qualified tuition program (QTP). For a QTP, this applies only to the amount of tax-free earnings that were distributed, not to the recovery of contributions to the program.
- Deduct qualified education expenses that have been paid with tax-free interest on U.S. savings bonds (Form 8815).
- Deduct qualified education expenses that have been paid with tax-free scholarship, grant, or employer- provided educational assistance.

Adjustments to Qualified Education Expenses

If you pay qualified education expenses with certain tax-free funds, you cannot claim a deduction for those amounts. You must reduce the qualified education expenses by the amount of any tax-free educational assistance and refund(s) you received.

Tax-free educational assistance includes:

- The tax-free part of scholarships and fellowships,
- Pell grants,
- Employer-provided educational assistance,
- Veterans' educational assistance, and
- Any other nontaxable (tax-free) payments (other than gifts or inheritances) received as educational assistance.

<u>Amounts That Do Not Reduce Qualified Education Expenses</u>
Do not reduce qualified education expenses by amounts paid with funds the student receives as:

- Payment for services, such as wages,
- A loan,
- A gift,
- An inheritance, or
- A withdrawal from the student's personal savings.

- Any scholarship or fellowship reported as income on the student's tax return in the following situations:
  - The use of the money is restricted to costs of attendance (such as room and board) other than qualified education expenses.
  - The use of the money is not restricted and is used to pay education expenses that are not qualified (such as room and board).

Expenses That Do Not Qualify

Qualified education expenses do not include amounts paid for:

- Insurance,
- Medical expenses (including student health fees),
- Room and board,
- Transportation, or
- Similar personal, living, or family expenses.

This is true even if the amount must be paid to the institution as a condition of enrollment or attendance.

Who Is An Eligible Student?

For purposes of the tuition and fees deduction, an eligible student is any student who is enrolled in one or more courses at an eligible educational institution.

Who Can Claim a Dependent's Expenses

If there are qualified education expenses for your dependent for a year, either you or your dependent, but not both of you, can claim a lifetime learning credit for your dependent's expenses for that year:

1. If you claim an exemption on your tax return for a dependent who is an eligible student, then only you can claim the credit based on that dependent's expenses. The dependent cannot claim the credit.

2. If you do not claim an exemption on your tax return for a dependent who is an eligible student (even if entitled to the exemption), then only the dependent can claim the credit. You cannot claim the credit based on this dependent's expenses.

Again, if your claim the eligible student as a dependent on your tax return, then any qualified education expenses paid by the dependent, or by a third party for that dependent, are considered paid by you.

Figuring The Deduction

The maximum tuition and fees deduction in 2013 is $4,000, $2,000, or $0, depending on the amount of your modified adjusted gross income (MAGI).

Form 1098-T

To help you figure your tuition and fees deduction, you should receive Form 1098-T. Generally, an eligible educational institution (such as a college or university) must send Form 1098-T (or acceptable substitute) to each enrolled student by February 2, 2014. An institution may choose to report either payments received (box 1), or amounts billed (box 2), for qualified education expenses. However, the amount in boxes 1 and 2 of Form 1098-T may be different than what you actually paid. When figuring the deduction, use only the amounts you paid in 2013 for qualified education expenses.

In addition, your Form 1098-T should give you other information for that institution, such as adjustments made for prior years, the amount of scholarships or grants, reimbursements or refunds, and whether you were enrolled at least half-time or were a graduate student.

The eligible educational institution may ask for a completed Form W-9S, Request for Student's or Borrower's Taxpayer Identification Number and Certification, or similar statement to obtain the student's name, address, and taxpayer identification number.

Income Phaseout vs. Amount Of Deduction

If your modified adjusted gross income (MAGI) is not more than $65,000 ($130,000 if you are married filing jointly), your maximum tuition and fees deduction is $4,000. If your MAGI is larger than $65,000 ($130,000), but is not more than $80,000 ($160,000 if you are married filing jointly), your maximum deduction is $2,000. No tuition and fees deduction is allowed if your MAGI is larger than $80,000 ($160,000).

How To Claim The Deduction

You claim a tuition and fees deduction by completing Form 8917 and submitting it with your Form 1040 or Form 1040A. Enter the deduction on Form 1040, line 34, or Form 1040A, line 19.

> **Planning Tip**: Although the tax impact of the tuition deduction is generally not as good as the American Opportunity credit or lifetime learning credit, there is a hidden benefit to this deduction. Since the tuition deduction reduces AGI, it can make the family eligible for

additional need-based aid during the academic year. If the aid is in the form of grants instead of loans, this deduction could potentially be better than the American Opportunity or lifetime learning credit.

Planning Tip: If the family has more than one enrolled in college at the same time and incurs qualified tuition and fees for both, the taxpayer may claim the American Opportunity or lifetime learning credit, along with the tuition and fees deduction on the same taxpayer return. This is done by claiming the American Opportunity or lifetime learning credit using one student's education expenses, and using the other student's education expenses for the tuition deduction.

Documents Used To Claim The Deduction

These are the documents you will need to implement the Tuition & Fees Deduction:

- Form 1098-T
- Form 8917

IRS Publications & Forms References

IRS Publications

Tax Benefits for Education
Publication 970, Tax Benefits for Education
http://www.irs.gov/pub/irs-pdf/p970.pdf

ection
6

Coverdell Education Savings Account

If your modified adjusted gross income (MAGI) is less than $110,000 ($220,000 if filing a joint return), you may be able to establish a Coverdell ESA to finance the qualified education expenses of a designated beneficiary.

What Is a Coverdell ESA?

A Coverdell ESA is a trust or custodial account created or organized in the United States only for the purpose of paying the qualified education expenses of the designated beneficiary of the account. When the account is established, the designated beneficiary must be under age 18, or a special needs beneficiary. To be treated as a Coverdell ESA, the account must be designated as a Coverdell ESA when it is created.

There is no limit on the number of separate Coverdell ESAs that can be established for a designated beneficiary. However, total contributions for the beneficiary in any year cannot be more than $2,000, no matter how many accounts have been established.

This benefit applies not only to higher education expenses, but also to elementary and secondary education expenses.

What Is The Tax Benefit Of The Coverdell ESA

Contributions to a Coverdell ESA are not deductible, but amounts deposited in the account grow tax free until distributed. If, for a year, distributions from an account are not more than a designated beneficiary's qualified education expenses at an eligible educational institution, the beneficiary will not owe tax on the distributions.

Eligible Educational Institutions

For purposes of Coverdell ESAs, an eligible educational institution can be either an eligible postsecondary school or an eligible elementary or secondary school.

Eligible Postsecondary School
This is any college, university, vocational school, or other postsecondary educational institution eligible to participate in a student aid program administered by the U.S. Department of Education. It includes virtually all accredited public, nonprofit, and proprietary (privately owned profit-making) postsecondary institutions.

Eligible Elementary Or Secondary School
This is any public, private, or religious school that provides elementary or secondary education (kindergarten through grade 12), as determined under state law.

Qualified Higher Education Expenses

Generally, these are expenses required for the enrollment or attendance of the designated beneficiary at an eligible educational institution. For purposes of Coverdell ESAs, the expenses can be either qualified higher education expenses or qualified elementary and secondary education expenses. A designated beneficiary is the individual named in the document creating the trust or custodial account to receive the benefit of the funds in the account.

The following expenses must be required for enrollment or attendance of a designated beneficiary at an eligible postsecondary school:

1. Tuition and fees.
2. Books, supplies, and equipment.
3. Expenses for special needs services needed by a special needs beneficiary must be incurred in connection with enrollment or attendance at an eligible postsecondary school. (See Caution earlier.)
4. Expenses for room and board must be incurred by students who are enrolled at least half-time (defined below).

The expense for room and board qualifies only to the extent that it is not more than the greater of the following two amounts:

1. The allowance for room and board, as determined by the school, that was included in the cost of attendance (for federal financial aid purposes) for a particular academic period and living arrangement of the student.
2. The actual amount charged if the student is residing in housing owned or operated by the school.

Any contribution to a qualified tuition program (QTP) must be on behalf of the designated beneficiary of the Coverdell ESA. In the case of a change in beneficiary, this is a qualified expense only if the new beneficiary is a family member of that designated beneficiary.

Qualified Elementary and Secondary Education Expenses

These are expenses related to enrollment or attendance at an eligible elementary or secondary school. As shown in the following list, to be qualified, some of the expenses must be required or provided by the school. And there are special rules for computer-related expenses.

The following expenses must be incurred by a designated beneficiary in connection with enrollment or attendance at an eligible elementary or secondary school:

1. Tuition and fees.
2. Books, supplies, and equipment.
3. Academic tutoring.
4. Special needs services for a special needs beneficiary.

The following expenses must be required or provided by an eligible elementary or secondary school in connection with attendance or enrollment at the school.

1. Room and board.
2. Uniforms.
3. Transportation.
4. Supplementary items and services (including extended day programs).

The purchase of computer technology, equipment, or Internet access and related services is a qualified elementary and secondary education expense if it is to be used by the beneficiary and the beneficiary's family during any of the years the beneficiary is in elementary or secondary school. (This does not include expenses for computer software designed for sports, games, or hobbies unless the software is predominantly educational in nature.)

Contributions

Any individual (including the designated beneficiary) can contribute to a Coverdell ESA if the individual's modified adjusted gross income (MAGI) for the year is less than $110,000. For individuals filing joint returns, that amount is $220,000.

Organizations, such as corporations and trusts, can also contribute to Coverdell ESAs. There is no requirement that an organization's income be below a certain level. Contributions must meet all of the following requirements.

- They must be in cash.
- They cannot be made after the beneficiary reaches age 18, unless the beneficiary is a special needs beneficiary, and
- They must be made by the due date of the contributor's tax return (not including extensions).

Contributions can be made to one or several Coverdell ESAs for the same designated beneficiary provided that the total contributions are not more than the contribution limits (defined later) for a year. Contributions can be made, without penalty, to both a Coverdell ESA and a QTP in the same year for the same beneficiary.

Contributions made to a Coverdell ESA for the preceding tax year are considered to have been made on the last day of the preceding year. They must be made by the due date (not including extensions) for filing your return for the preceding year.

> **Example**: If you make a contribution to a Coverdell ESA in February 2013, and you designate it as a contribution for 2013, you are considered to have made that contribution on December 31, 2013.

Contribution Limits

There are two yearly limits for Coverdell ESAs:

1. One on the total amount that can be contributed for each designated beneficiary in any year, and
2. One on the amount that any individual can contribute for any one designated beneficiary for a year.

<u>Limit For Each Designated Beneficiary</u>
For 2013, the total of all contributions to all Coverdell ESAs set up for the benefit of any one designated beneficiary cannot be more than $2,000. This includes contributions (other than rollovers) to all of the beneficiary's Coverdell ESAs from all sources.

<u>Limit For Each Contributor</u>
Generally, you can contribute up to $2,000 for each designated beneficiary for 2013. This is the most you can contribute for the benefit of any one beneficiary for the year, regardless of the number of Coverdell ESAs set up for the beneficiary.

> **Planning tip**: As a planning strategy, a taxpayer who had Modified AGI in excess of the phase-out limits could gift the cash to another taxpayer (possibly the beneficiary of the Coverdell ESA) with Modified AGI less

than the phase-out limits. This taxpayer could then make the maximum contribution of $2,000.

Planning tip: Corporations and other non-individual entities, including tax-exempt organizations, are permitted to make contributions to Coverdell ESAs, regardless of the income of the corporation or entity during the year of the contribution.

Planning tip: If a client has invested in a Coverdell ESA, the client can roll the Coverdell ESAs, tax-free, into a 529 Plan for the same beneficiary and possibly receive a state income tax benefit for the rollover to the 529 Plan.

Rollovers

Assets can be rolled over from one Coverdell ESA to another, or the designated beneficiary can be changed. The beneficiary's interest can be transferred to a spouse or former spouse because of divorce.

An amount is rolled over if it is paid to another Coverdell ESA within 60 days after the date of the distribution.

Any amount distributed from a Coverdell ESA is not taxable if it is rolled over to another Coverdell ESA for the benefit of the same beneficiary or a member of the beneficiary's family (including the beneficiary's spouse) who is under age 30. This age limitation does not apply if the new beneficiary is a special needs beneficiary.

Members Of The Beneficiary's Family

For the purposes of rolling over one Coverdell ESA to another, the beneficiary's family includes the beneficiary's spouse and the following other relatives of the beneficiary:

- Son, daughter, stepchild, foster child, adopted child, or a descendant of any of them
- Brother, sister, stepbrother, or stepsister
- Father or mother or ancestor of either
- Stepfather or stepmother
- Son or daughter of a brother or sister
- Brother or sister of father or mother

- Son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law
- The spouse of any individual listed above
- First cousin

Furthermore, the designated beneficiary can be changed to a member of the beneficiary's family (defined above). There are no tax consequences if, at the time of the change, the new beneficiary is under age 30 or a special needs beneficiary.

Distributions

The designated beneficiary of a Coverdell ESA can take a distribution at any time. Whether the distributions are tax free depends, in part, on whether the distributions are equal to or less than the amount of "adjusted qualified education expenses" that the beneficiary has in the same tax year.

- If the distributions are EQUAL TO or LESS THAN the adjusted qualified education expenses then the entire distribution is tax-free.

Adjusted Qualified Education Expenses

To determine the amount of "adjusted" qualified education expenses, reduce your total qualified education expenses by any tax-free educational assistance. Tax-free educational assistance includes:

- The tax-free part of scholarships and fellowships,
- Veterans' educational assistance,
- Pell grants,
- Employer-provided educational assistance, and
- Any other nontaxable (tax-free) payments (other than gifts or inheritances) received as educational assistance.

The amount you get by subtracting tax-free educational assistance from your total qualified education expenses is your adjusted qualified education expenses.

Earnings And Return Of Investment

You will receive a Form 1099-Q, Payments From Qualified Education Programs from each of the programs from which you received a Coverdell

ESA distribution in 2013. The amount of your gross distribution (box 1) shown on each form will be divided between your earnings (box 2) and your basis, or return of investment (box 3). Form 1099-Q should be sent to you by February 2, 2014.

When Must Assets Be Distributed?

Any assets remaining in a Coverdell ESA must be distributed when either one of the following two events occurs.

1. The designated beneficiary reaches age 30. In this case, the remaining assets must be distributed within 30 days after the beneficiary reaches age 30. However, this rule does not apply if the beneficiary is a special needs beneficiary.

2. The designated beneficiary dies before reaching age 30. In this case, the remaining assets must generally be distributed within 30 days after the date of death.

Exception for Transfer to Surviving Spouse or Family Member

If a Coverdell ESA is transferred to a surviving spouse or other family member as the result of the death of the designated beneficiary, the Coverdell ESA retains its status. (“Family member” was defined earlier under Rollovers.) This means the spouse or other family member can treat the Coverdell ESA as his or her own and does not need to withdraw the assets until he or she reaches age 30. This age limitation does not apply if the new beneficiary is a special needs beneficiary. There are no tax consequences as a result of the transfer.

Implementing The Coverdell ESA

When the account is established, the designated beneficiary must be under age 18 or a special needs beneficiary.

To be treated as a Coverdell ESA, the account must be designated as a Coverdell ESA when it is created.

The document creating and governing the account must be in writing and must satisfy the following requirements:

1. The trustee or custodian must be a bank or an entity approved by the IRS.

2. The document must provide that the trustee or custodian can only accept a contribution that meets all of the following conditions.

    a. The contribution is in cash.

b. The contribution is made before the beneficiary reaches age 18, unless the beneficiary is a special needs beneficiary.

c. The contribution would not result in total contributions for the year (not including rollover contributions) being more than $2,000.

3. Money in the account cannot be invested in life insurance contracts.

4. Money in the account cannot be combined with other property except in a common trust fund or common investment fund.

5. The balance in the account generally must be distributed within 30 days after the earlier of the following events:

    a. The beneficiary reaches age 30, unless the beneficiary is a special needs beneficiary.

    b. The beneficiary's death.

Documents Used For The Coverdell ESA

These are the documents you will need to use for the Coverdell ESA:

- Form 1099-Q

IRS Publications & Forms References

IRS Publications

Tax Benefits for Education
Publication 970, Tax Benefits for Education
http://www.irs.gov/pub/irs-pdf/p970.pdf

Section

7

Qualified Tuition Program (529 Plan)

States may establish and maintain programs that allow you to either prepay or contribute to an account for paying a student's qualified education expenses at a postsecondary institution. These accounts are called qualified tuition programs (QTPs), or “529 plans.” If you prepay tuition, the student (designated beneficiary) will be entitled to a waiver or a payment of qualified education expenses. You cannot deduct either payments or contributions to a QTP.

> *Note: For information on a specific QTP, you will need to contact the state agency or eligible educational institution that established and maintains it.*

What Is a Qualified Tuition Program?

A qualified tuition program (QTP) is a program set up to allow you to either prepay, or contribute to an account established for paying, a student's qualified education expenses at an eligible educational institution. QTPs can be established and maintained by states (or agencies or instrumentalities of a state) and eligible educational institutions.

What Is The Tax Benefit Of A QTP?

No tax is due on a distribution from a QTP unless the amount distributed is greater than the beneficiary's adjusted qualified education expenses.

Eligible Educational Institutions

For purposes of a QTP, this is any college, university, vocational school, or other postsecondary educational institution eligible to participate in a student aid program administered by the U.S. Department of Education. It includes virtually all accredited public, nonprofit, and proprietary (privately owned profit-making) postsecondary institutions.

Qualified Higher Education Expenses

Qualified education expenses are the amounts paid for tuition, fees, books, supplies, and equipment required for enrollment or attendance at an eligible educational institution.

They also include the reasonable costs of room and board for a designated beneficiary who is at least a half-time student. The cost of room and board qualifies only to the extent that it is not more than the greater of the following two amounts:

1. The allowance for room and board, as determined by the eligible educational institution, that was included in the cost of attendance (for federal financial aid purposes) for a particular academic period and living arrangement of the student.

2. The actual amount charged if the student is residing in housing owned or operated by the eligible educational institution.

You will need to contact the eligible educational institution for their qualified room and board costs.

The definition of qualified education expenses was expanded to include expenses of a special needs beneficiary that are necessary for that person's enrollment or attendance at an eligible educational institution.

Designated Beneficiary

The designated beneficiary is generally the student (or future student) for whom the QTP is intended to provide benefits. The designated beneficiary can be changed after participation in the QTP begins. If a state or local government or certain tax-exempt organizations purchase an interest in a QTP as part of a scholarship program, the designated beneficiary is the person who receives the interest as a scholarship.

Contributions

Contributions to a QTP on behalf of any beneficiary cannot be more than the amount necessary to provide for the qualified education expenses of the beneficiary. There are no income restrictions on the individual contributors.

You can contribute to both a QTP and a Coverdell ESA in the same year for the same designated beneficiary.

Rollovers

Assets can be rolled over from one QTP to another, or the designated beneficiary can be changed. The beneficiary's interest can be transferred to a spouse or former spouse because of divorce.

An amount is rolled over if it is paid to another QTP within 60 days after the date of the distribution.

Any amount distributed from a QTP is not taxable if it is rolled over to another QTP for the benefit of the same beneficiary or a member of the beneficiary's family (including the beneficiary's spouse) who is under age 30. This age limitation does not apply if the new beneficiary is a special needs beneficiary.

Members Of The Beneficiary's Family

For the purposes of rolling over one QTP to another, the beneficiary's family includes the beneficiary's spouse and the following other relatives of the beneficiary:

- Son, daughter, stepchild, foster child, adopted child, or a descendant of any of them
- Brother, sister, stepbrother, or stepsister
- Father or mother or ancestor of either
- Stepfather or stepmother
- Son or daughter of a brother or sister
- Brother or sister of father or mother
- Son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law
- The spouse of any individual listed above
- First cousin

Furthermore, the designated beneficiary can be changed to a member of the beneficiary's family (defined above). There are no tax consequences if, at the time of the change, the new beneficiary is under age 30 or a special needs beneficiary.

Distributions

The part of a distribution representing the amount paid or contributed to a QTP does not have to be included in income. Furthermore, the designated beneficiary does not have to include in income any earnings distributed from a QTP, if the total distribution is less than or equal to the "adjusted qualified educations". In other words:

- If the distributions are EQUAL TO or LESS THAN the adjusted qualified education expenses then the entire distribution is tax-free.

Adjusted Qualified Education Expenses

To determine the amount of "adjusted" qualified education expenses, reduce your total qualified education expenses by any tax-free educational assistance. Tax-free educational assistance includes:

- The tax-free part of scholarships and fellowships,
- Veterans' educational assistance,
- Pell grants,
- Employer-provided educational assistance, and
- Any other nontaxable (tax-free) payments (other than gifts or inheritances) received as educational assistance.

The amount you get by subtracting tax-free educational assistance from your total qualified education expenses is your adjusted qualified education expenses.

Earnings And Return Of Investment

You will receive a Form 1099-Q, Payments From Qualified Education Programs (Under Sections 529 and 530), from each of the programs from which you received a QTP distribution in 2013. The amount of your gross distribution (box 1) shown on each form will be divided between your earnings (box 2) and your basis, or return of investment (box 3). Form 1099-Q should be sent to you by February 2, 2014.

Documents Used For The QTP

These are the documents you will need to implement the Qualified Tuition Plan:

- Form 1099-Q

IRS Publications & Forms References

IRS Publications

Tax Benefits for Education
Publication 970, Tax Benefits for Education
http://www.irs.gov/pub/irs-pdf/p970.pdf

Section

8

Penalty-Free Distributions From IRAs Used For Education

Generally, if you take a distribution from your IRA before you reach age 59½, you must pay a 10% additional tax on the early distribution. This applies to any IRA you own, whether it is a traditional IRA (including a SEP-IRA), a Roth IRA, or a SIMPLE IRA.

However, you can take distributions from your IRAs for qualified higher education expenses without having to pay the 10% additional tax. You may owe income tax on at least part of the amount distributed, but you may not have to pay the 10% additional tax.

Who Is Eligible?

You can take a distribution from your IRA before you reach age 59½ and not have to pay the 10% additional tax if, for the year of the distribution, you pay qualified education expenses for:

- yourself,
- your spouse, or
- your or your spouse's child, foster child, adopted child, or descendant of any of them.

Eligible Educational Institutions

An eligible educational institution is any college, university, vocational school, or other postsecondary educational institution eligible to participate in a student aid program administered by the U.S. Department of Education. It includes virtually all accredited public, nonprofit, and proprietary (privately owned profit-making) postsecondary institutions. The educational institution should be able to tell you if it is an eligible educational institution.

What Education Expenses Qualify

For purposes of the 10% additional tax, the qualified expenses are tuition, fees, books, supplies, and equipment required for enrollment or attendance at an eligible educational institution. They also include expenses for special needs services incurred by or for special needs students in connection with their enrollment or attendance.

In addition, if the student is at least a half-time student, room and board is considered as qualified education expenses. The expense for room and board qualifies only to the extent that it is not more than the greater of the following two amounts.

- The allowance for room and board, as determined by the eligible educational institution, that was included in the cost of attendance (for federal financial aid purposes) for a particular academic period and living arrangement of the student.

- The actual amount charged if the student is residing in housing owned or operated by the eligible educational institution.

You will need to contact the eligible educational institution for qualified room and board costs.

Figuring The Amount Exempt From The 10% Additional Tax

To determine the amount of your distribution that is not subject to the 10% additional tax, first figure your adjusted qualified education expenses. You do this by reducing your total qualified education expenses by any tax-free educational assistance, which includes:

- Expenses used to figure the tax-free portion of distributions from a Coverdell education savings account,
- The tax-free part of scholarships and fellowships,,
- Pell grants,
- Veterans' educational assistance,
- Employer-provided educational assistance, and
- Any other nontaxable (tax-free) payments (other than gifts or inheritances) received as educational assistance.

Do not reduce the qualified education expenses by amounts paid with funds the student receives as:

- Payment for services, such as wages,
- A loan,

- A gift,
- An inheritance given to either the student or the individual making the withdrawal, or
- A withdrawal from personal savings (including savings from a qualified tuition program (QTP)).

If your IRA distribution is equal to or less than your adjusted qualified education expenses, you are not subject to the 10% additional tax.

Reporting Early Distributions

By February 2, 2014, the payer of your IRA distribution should send you Form 1099-R, Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc. The information on this form will help you determine how much of your distribution is taxable for income tax purposes and how much is subject to the 10% additional tax.

If you received an early distribution from your IRA, you must report the taxable earnings on Form 1040, line 15b (Form 1040NR, line 16b). Then, if you qualify for an exception for qualified higher education expenses, you must file Form 5329 to show how much, if any, of your early distribution is subject to the 10% additional tax.

Documents Used For Early Distributions From IRAs

These are the documents you will need to use with an early distribution from an IRA:

- Form 1099-R
- Form 5329

IRS Publications & Forms References

IRS Publications

Tax Benefits for Education
Publication 970, Tax Benefits for Education
http://www.irs.gov/pub/irs-pdf/p970.pdf

Section

9

Tax-Free Distributions From Savings Bonds Used For Education

Generally, you must pay tax on the interest earned on U.S. savings bonds. If you do not include the interest in income in the years it is earned, you must include it in your income in the year in which you cash in the bonds. However, when you cash in certain savings bonds under an education savings bond program, you may be able to exclude the interest from income.

Who Can Cash In Bonds Tax Free?

You may be able to cash in qualified U.S. savings bonds without having to include in your income some or all of the interest earned on the bonds if you meet the following conditions:

- You pay qualified education expenses for yourself, your spouse, or a dependent for whom you claim an exemption on your return.
- Your modified adjusted gross income (MAGI) is less than $87,850 ($139,250 if married filing jointly or qualifying widow(er)).
- Your filing status is not married filing separately.

What Is A Qualified U.S. Savings Bond?

A qualified U.S. savings bond is a series EE bond issued after 1989 or a series I bond. The bond must be issued either in your name (as the sole owner) or in the name of both you and your spouse (as co-owners).

The owner must be at least 24 years old before the bond's issue date. The issue date is printed on the front of the savings bond. The issue date is not necessarily the date of purchase – it will be the first day of the month in which the bond is purchased.

Eligible Educational Institutions

An eligible educational institution is any college, university, vocational school, or other postsecondary educational institution eligible to participate in a student aid program administered by the U.S. Department of Education. It includes virtually all accredited public, nonprofit, and proprietary (privately owned profit-making) postsecondary institutions. The educational institution should be able to tell you if it is an eligible educational institution.

What Education Expenses Qualify?

Qualified education expenses include the following items you pay for either yourself, your spouse, or a dependent for whom you claim an exemption:

1. Tuition and fees required to enroll at or attend an eligible educational institution. Qualified education expenses do not include expenses for room and board or for courses involving sports, games, or hobbies that are not part of a degree or certificate granting program.

2. Contributions to a qualified tuition program (QTP).

3. Contributions to a Coverdell education savings account (ESA).

Adjusted Qualified Education Expenses

You must reduce your qualified education expenses by all of the following tax-free benefits:

1. Tax-free part of scholarships and fellowships

2. Expenses used to figure the tax-free portion of distributions from a Coverdell ESA

3. Expenses used to figure the tax-free portion of distributions from a QTP

4. Any tax-free payments (other than gifts or inheritances) received as educational assistance, such as:

    a. Veterans' educational assistance benefits,
    b. Qualified tuition reductions, or
    c. Employer-provided educational assistance.

5. Any expenses used in figuring the Hope and lifetime learning credits.

Figuring The Tax Free Amount

If the total you receive when you cash in the bonds is not more than the adjusted qualified education expenses for the year, all of the interest on the bonds may be tax free. However, if the total you receive when you cash in the bonds is more than the adjusted expenses, only part of the interest may be tax free.

To determine the tax-free amount, multiply the interest part of the proceeds by a fraction. The numerator (top part) of the fraction is the adjusted qualified education expenses you paid during the year. The denominator (bottom part) of the fraction is the total proceeds you received during the year.

Income Phaseout vs. Amount of Exclusion

The amount of your interest exclusion is gradually reduced (phased out) if your modified adjusted gross income is between $72,850 and $87,850 (between $109,250 and $139,250 if your filing status is married filing jointly or qualifying widow(er)). You cannot exclude any of the interest if your modified adjusted gross income is equal to or more than the upper limit.

Documents Used For Tax-Free Distributions From Savings Bonds

These are the documents you will need to use with tax-free distributions from savings bonds:

- Form 8815
- IRS Form 1040, Schedule B

IRS Publications & Forms References

IRS Publications

Tax Benefits for Education
Publication 970, Tax Benefits for Education
http://www.irs.gov/pub/irs-pdf/p970.pdf

APPENDIX A

Documents Used To Implement Education Tax Benefits

The following is a listing of the documents needed to report the various education tax benefits:

American Opportunity Tax Credit

1. Form 1098-T http://www.irs.gov/pub/irs-pdf/f1098t.pdf
2. Form 8863 http://www.irs.gov/pub/irs-pdf/f8863.pdf
3. Form 1040, line 50 http://www.irs.gov/pub/irs-pdf/f1040.pdf

Lifetime Learning Tax Credit

1. Form 1098-T http://www.irs.gov/pub/irs-pdf/f1098t.pdf
2. Form 8863 http://www.irs.gov/pub/irs-pdf/f8863.pdf
3. Form 1040, line 50 http://www.irs.gov/pub/irs-pdf/f1040.pdf

Student Loan Interest Deduction

1. Form 1098-R http://www.irs.gov/pub/irs-pdf/f1098e.pdf
2. Form 1040, line 33 http://www.irs.gov/pub/irs-pdf/f1040.pdf

Tuition & Fees Deduction

1. Form 1098-T http://www.irs.gov/pub/irs-pdf/f1098t.pdf
2. Form 8917 http://www.irs.gov/pub/irs-pdf/f8917.pdf
3. Form 1040, line 34 http://www.irs.gov/pub/irs-pdf/f1040.pdf

Coverdell Education Savings Account

1. Form 1099-Q http://www.irs.gov/pub/irs-pdf/f1099q.pdf
2. Form 1040, line 21 http://www.irs.gov/pub/irs-pdf/f1040.pdf
3.

Qualified Tuition Plan (529 Plan)

1. Form 1099-Q http://www.irs.gov/pub/irs-pdf/f1099q.pdf
2. Form 1040, line 21 http://www.irs.gov/pub/irs-pdf/f1040.pdf

Penalty-Free Distributions From IRAs

1. Form 1099-R http://www.irs.gov/pub/irs-pdf/f1099r.pdf
2. Form 5329 http://www.irs.gov/pub/irs-pdf/f5329.pdf
3. Form 1040, line 15b http://www.irs.gov/pub/irs-pdf/f1040.pdf

Tax-Free Distributions From Savings Bonds

1. Form 8815 http://www.irs.gov/pub/irs-pdf/f8815.pdf
2. Form 1040, Schedule B, line 3 http://www.irs.gov/pub/irs-pdf/f1040sb.pdf