By Charles Herbst

Federal tax benefits for financing college: Will Congress renege?

Over the past decade or so, Congress has passed a number of tax bills with provisions that significantly reduce the tax burden on college students and their families.

The latest effort, the Economic Growth and Tax Relief Reconciliation Act of 2001, "EGTRRA,"[1] (P.L. 107-16) greatly liberalizes the terms of many of these programs. Unfortunately, EGTRRA is set to expire at the end of 2010. This expiration greatly affects planning for the education of children born in the 1990s and beyond. A child born in 1992 will reach age 18 in 2011, the year after the repeal.

Congress has taken a piecemeal, rather than a coordinated approach. As a result, the tax breaks are scattered throughout the Internal Revenue Code. The provisions are not only difficult to catalogue, but also complex and difficult to reconcile.

This article has three purposes. First, to catalogue the major tax benefits available.[2] Second, to discuss the implications of the EGTRRA expiration. Third, to explore whether disclosures should be made to clients who are relying on tax benefits to finance the education of young children. This article is intended to acquaint and serve as a checklist of the common programs that a planner might utilize in structuring college financing. It is not intended to be a complete explanation of the various provisions.[3]

Some preliminary considerations

The relative wealth of the taxpayer will often determine which program yields the greatest benefit. Hope Scholarship Credits benefit lower-income individuals. Qualified Tuition Plans benefit those with discretionary income. Gift tax exclusions benefit millionaires. Because several of the programs are mutually exclusive, it is often necessary to compare one's after-tax position under different strategies. Unfortunately, lower-income families often lack access to this sort of complex financial planning.

In addition to the plans described, there are a variety of other, less-used possibilities. For example, Code Sec. 72(t)(7)[4] permits a penalty-free withdrawal from an IRA or Roth IRA for qualified educational expenses. Generally, however, the programs described below are better options for college savings, because such withdrawals would reduce the amount that ultimately could be contributed under these programs toward retirement.

Finally, students who might otherwise qualify for need-based scholarships, grants and low-interest loans may be (and often are) penalized for their parents' thrift. In addition, whether funds are regarded as property of a parent or student often makes a difference in how much is "expected"[5] to be contributed toward college expenses. Because of the evolving nature and use of newer programs, continuing adjustments to these contribution formulas are likely.

Saving for college

1. Qualified Tuition Programs. Code Sec. 529 allows a taxpayer to make contributions to a state-sponsored savings plan or purchase prepaid tuition credits on behalf of a designated beneficiary. The program has been expanded to include participating private colleges and universities as sponsors of such Qualified Tuition Plans.

Contributions to Qualified Tuition Plans are not tax deductible on the federal level. Although there are no limits on the amount that can be contributed as such, each program is required to provide safeguards to prevent contributions that are in excess of the amount necessary to finance qualified higher education expenditures.[6] Income from Qualified Tuition Plans will not be taxed if it is distributed to a beneficiary for qualified higher education expenses, consisting of tuition, fees, books, supplies, equipment, and (if at least a half-time student) room and board.[7] If, however, the funds are distributed to a beneficiary for a purpose other than to meet qualifying expenses, the income earned by the account will be taxable to the beneficiary. An additional 10 percent tax will also apply.[8]

Qualified Tuition Programs are proving exceedingly popular and are evolving quickly. The terms of these plans vary greatly. One of the best resources for current information regarding the various plans has been the Web site, *www.savingforcollege.com*. This Web site provides details and contact information regarding various states' plans. Taxpayers are not limited to their home state's plan and can choose which plan best suits their needs.[9] The IRS has issued a notice stating that taxpayers may change plans a maximum of once per year or at any time that there is a change in the beneficiary. These plans may allow participants to select only from among broad-based investment strategies, rather than more specific or self-directed plans.[10]

Qualified Tuition Plan contributions are considered completed gifts and are charged against a taxpayer's annual gift exclusion or unified credit amount. (The contributions are not considered excludable tuition payments under Code Sec. 2503(e)(2)(A).) If the contribution exceeds the Code Sec. 2503(b) annual limit (currently $11,000), the contributor can elect

to take the contribution into account ratably over a five-year period beginning with the year of the contribution.[11] Despite their nature as completed gifts, the contributions remain the property of the contributor and are transferable to a related beneficiary or different Qualified Tuition Program.

2. Coverdell Education Savings Accounts (formerly Education IRAs). Code Sec. 530 permits a taxpayer to contribute up to $2,000 in cash per year per beneficiary into a special savings account for the beneficiary's education. The $2,000 per beneficiary limit is applied to the total contributed by all taxpayers on behalf of the beneficiary.[12] If excess contributions are made, a 6 percent annual excise tax applies.[13]

Coverdell Accounts are phased out when the contributing taxpayer's modified adjusted gross income reaches the $95,000 to $110,000 range for single taxpayers and $190,000 to $220,000 for joint filers.[14] These contribution and limit amounts are not indexed for inflation.

Like Qualified Tuition Plan contributions, Coverdell Account contributions are considered completed gifts and are charged against a taxpayer's annual gift exclusion or unified credit amount. (The contributions are not considered excludable tuition payments under Code Sec. 2503(e)(2)(A).)

Although contributions to the account are not tax deductible, the interest earned on the account is not taxed, provided that the proceeds are used for the beneficiary's educational expenses. EGTRRA expanded this program to permit tax-free withdrawals for elementary and secondary education expenses, including uniforms and computer technology expenses, as well as higher education costs.[15]

Contributions may be made only on behalf of beneficiaries who are under 18 years of age, and account balances must be distributed no later than 30 days after the beneficiary's 30th birthday. These age restrictions do not apply to special needs beneficiaries. If the funds are not used for the beneficiary's education, they may be rolled over for the use of another related beneficiary who is under age 30, without penalty.[16] If the funds are distributed for a purpose other than to meet qualifying expenses, or are not distributed by age 30, the income earned by the account will be taxable to the beneficiary, and an additional 10 percent tax will apply.[17]

If both a Qualified Tuition Plan contribution and a Coverdell Account contribution are made in the same year, the $2,000 limit will apply to the aggregate contributions made to both types of accounts on behalf of the beneficiary.[18]

Coverdell Account withdrawals may occur in the same year that a Qualified Tuition Plan withdrawal is made, or Hope Scholarship Credit or Lifetime Learning Credit is taken, provided that the withdrawal does not cover the same expenses as the credit or other withdrawal.[19]

Although EGTRRA greatly liberalized the terms of both Qualified Tuition Plans and Coverdell Accounts, for most taxpayers, the much richer provisions of Qualified Tuition Plans supersede these accounts. However, there are several important exceptions: Unlike Qualified Tuition Plans, Coverdell Accounts can now be used for elementary and secondary school.[20] Conversion of existing Coverdell Accounts to a Qualified Tuition Plan may be difficult because Coverdell Accounts are considered the student beneficiary's property, rather than the contributor's, as is the case in a Qualified Tuition Plan.[21]

3. U.S. Savings Bond Redemptions. Code Sec. 135 provides an extremely limited exclusion from income for the proceeds of U.S. savings bonds. The bonds must be redeemed in the same year that qualified higher education expenses are paid. Qualified higher education expenses include tuition and fees for the taxpayer, spouse or dependent at an eligible educational institution.[22] They also include contributions to Qualified Tuition Plans or a Coverdell Account. But, unlike direct use of savings bond proceeds, note that "rollovers" to these other programs may ultimately be used to cover qualified room-and-board expenses. As qualified bonds mature, planners should consider whether these bonds should be contributed to a Qualified Tuition Plan or a Coverdell Account.

The exclusion applies only to bonds issued after 1989 to persons who were at least 24 on the issue date.[23] In addition, the exclusion is phased out for single filers with modified adjusted gross income of $57,600 to $72,600 and joint filers at the $86,400 to $116,400 range.[24] These amounts are adjusted for inflation.[25] Married persons filing separately may not utilize this exclusion.[26] Hope Scholarship Credits, Lifetime Learning Credits, Qualified Scholarships and Employee Educational Assistance Programs all reduce the amount of qualified higher education expenses that will offset the savings bond redemption. Similarly, eligibility will be reduced to the extent that qualified higher education expenses are being met by a Qualified Tuition Plan or Coverdell Account withdrawal.[27]

Paying for college

4. Scholarships/Tuition Reduction. Code Sec. 117 excludes qualified scholarships from income. Qualified scholarships can cover required tuition and fees as well as books, supplies and equipment.[28] If a student is required to teach, provide research or other services in exchange for the scholarship or tuition reduction, the exclusion from income does not apply.[29]

Tuition reductions for the employees of educational organizations, and spouses and dependents of employees, are also excluded from income. This exclusion includes only education below the graduate level.[30] An exception to the undergraduate rule is made for qualified tuition reduction programs for graduate students who are teaching or engaged in research activities for the organization.[31] Tuition reductions may be provided to a student at an educational institution other than the one at which the employee is employed.[32]

To qualify, a tuition reduction program will only apply to highly compensated employees if the program does not discriminate in favor of those employees who are highly compensated.[33]

5. Employer Educational Assistance Programs. Code Sec. 127 permits an employer to provide an employee with up to $5,250 in nontaxable educational assistance. This amount is not indexed for inflation. This benefit may be used only for the education of the employee.[34] This cost is also deductible to the employer. EGTRRA "permanently" extends this previously expiring program. In addition, EGTRRA extends the scope of the benefit to include graduate studies. Nontaxable educational assistance includes tuition, fees, books and similar expenses, and specifically excludes meals, lodging and transportation.[35] The benefit will not be excluded from income if it qualifies the employee to pursue a different line of work.

To qualify for the employer's tax deduction and the exclusion from the employee's income, these benefits must be provided according to the terms of a formal, written plan that meets the requirements of Code Sec. 127(b). Collectively, in any given year, no more than 5 percent of the total amount paid by the employer may be paid to those who are 5 percent (or more) owners of the business.[36] Employees who benefit from this program are precluded from taking other deductions or credits with respect to the same expenses covered by the exclusion from income under this program. A similar rule applies for amounts withdrawn from a Qualified Tuition Plan or Coverdell Account.[37]

6. Gift Tax Exclusion. Code Sec. 2503(e)(2)(A) excludes tuition payments from the scope of the gift tax. In addition, such tuition payments are outside the scope of the generation-skipping transfer tax.[38] To qualify, the payments must be made by the donor directly to the educational institution. The donor need not be related to the donee.

For millionaires, this gift tax exclusion provides a means to transfer additional wealth without utilizing the annual exclusion, unified credit or generation-skipping transfer tax exemption. For those fortunate enough to be able to "write a check" when the tuition becomes due, taxpayers may find this exemption more lucrative than consuming otherwise valuable estate, gift and generation-skipping tax exemptions necessary to utilize a Qualified Tuition Plan or Coverdell Account. This would be particularly significant for taxpayers with annual giving programs, such as irrevocable life insurance (Crummey) trusts. Moreover, such donors may well have an income that exceeds the income limitations placed on the savings plans.

One strategy might be for the parents to consider establishing a Qualified Tuition Plan. If all goes well, the grandparent could pay tuition. After paying other qualified expenses from the Qualified Tuition Plan, the taxpayer could seek a refund of the Qualified Tuition Plan, offsetting the penalty against the tax deferral benefits of the plan. Alternatively, the Qualified Tuition Plan could be transferred to a different beneficiary.[39]

7. Deduction for Qualified Tuition and Related Expenses. Code Sec. 222 permits a deduction for qualified tuition and related expenses of up to $3,000 for 2002. The deduction is limited to taxpayers with incomes of up to $65,000

for single taxpayers and $130,000 for married taxpayers filing jointly.[40] The amount of the deduction and limits vary in later years. This provision expires at the end of 2005.

Tax-free Scholarships and Employer Educational Assistance both reduce the amount of this deduction. Anti-"double benefit" rules deny the use of the deduction if Hope Scholarship Credits or Lifetime Learning Credits are used. The amount of the deduction under this section is also reduced by amounts equal to the deductions claimed for U.S. Savings Bond Redemptions and withdrawals of tax-free income from Qualified Tuition Programs and Coverdell Accounts.[41]

8. Hope Scholarship Credit/Lifetime Learning Credit. Code Sec. 25A permits a taxpayer to either claim a Hope Scholarship Credit or Lifetime Learning Credit during a year in which the taxpayer pays a student's qualified tuition expenses.[42] To claim either of these credits the student must be the taxpayer, spouse or the taxpayer's dependent.[43]

The Hope Scholarship Credit is equal to the lesser of qualified tuition expenses paid or $1,500 for each of the first two years of college.[44] The Hope Scholarship Credit is not available if a student has been convicted of a controlled substance felony prior to the end of the tax year.

The Lifetime Learning Credit allows a taxpayer to claim an offsetting credit of 20 percent of qualified tuition expenses in any year that the Hope Scholarship Credit is not claimed. The maximum amount of qualified tuition expenses that can be offset in a given year is $1,000.[45]

For each student's qualified tuition expenses, the taxpayer must elect among claiming one of these two credits or taking the Deduction for Qualified Tuition.[46] The credits are reduced by any amount excluded from income as scholarships or Employer Educational Assistance.[47] EGTRRA permits taking either of these credits in the same year as a Qualified Tuition Plan or Coverdell Account withdrawal, provided the credits are not used for the same expenses as the withdrawal.[48]

Both the Hope Scholarship and Lifetime Learning Credits are phased out when the taxpayer's modified adjusted gross income reaches the $40,000 to $50,000 range for single taxpayers and $80,000 to $100,000 for joint filers.[49] Both the amounts of the credits and income limitations are adjusted for inflation.[50]

Borrowing for college

9. Deductibility of Student Loan Interest. Code Sec. 221 permits individuals to deduct up to $2,500 of student loan interest payments made during the year. This includes voluntary payment of interest during forbearance periods. Married couples must file a joint return to claim this deduction. The deduction is phased out for single taxpayers making between $50,000 to $65,000 and $100,000 to $130,000 for joint filers.[51] These income ceilings will be adjusted for inflation for years after 2002.[52]

Will Congress renege?

Laws change. As any financial planner knows, there is no assurance that the tax treatment of a particular item of income or expense will remain constant over time. Generally, planners plan on the basis of current law.

Here, the archetype is different. Act Sec. 901 of EGTRRA repeals all of the provisions of this legislation on Dec. 31, 2010. As a result, current law is that EGTRRA and all its provisions do not apply to 2011 and beyond. Generally speaking, children born in 1992 will reach college age in 2011. Yet, many planners are treating many of these programs and their EGTRRA provisions as permanent. A more accu-

rate approach when planning for younger children is that, at the time of college matriculation, an expired EGTRRA is the current state of the law.

Despite the inevitable changes, the most sensible course of action may be to rely on these provisions for the time being, but remain flexible. Although many predict that Congress will extend these benefits, there are clearly no warranties, and planners should disclose this uncertainty to their clients. Those who believe that Congress will not reduce or remove the tax benefits afforded to students and their parents should revisit changes made by the Tax Reform Act of 1986[53] during the Reagan Administration. After encouraging students to borrow utilizing federal loan programs, the terms of repayment were changed. Prior to 1987, student loan interest was deductible, allowing students to pay the interest on a pretax basis.[54] After the Tax Reform Act of 1986 took effect, student loan interest was no longer deductible.

Teaching supplies deduction

Many teachers pay for school supplies out of their own pocket and are unreimbursed for such expenses. Often they have been unable to itemize these expenses as deductions. As we go to press, the Job Creation and Worker Assistance Act of 2002, P.L. 107-147, amends Code Sec. 62(a)(2)(D), adding a $250 per year above-the-line deduction for eligible educators who pay for or incur expenses in connection with books, supplies, computer equipment (including software and such), other services and supplementary materials used by the educator in the classroom. "Eligible educator" is a K-12 teacher, instructor, counselor, principal or aide who works 900 hours during the school year. The deduction applies for 2002 and 2003. Although the relief provided by this new deduction is limited, most teachers should be able to benefit from it. ⚖

Effects of EGTRRA's expiration

Under current law, these are some of the major changes that will happen in 2011 to these programs:

Qualified Tuition Plans: Private colleges and universities will no longer be eligible to sponsor these plans. Withdrawals will be taxed at the student's income tax rate.

Coverdell Education Savings Accounts: tax-free withdrawals for only higher education expenses (no elementary, secondary or computer expenses). Contributions will be limited to $500 per year per beneficiary.

Employer Educational Assistance Programs: This program will expire. Some benefits may be available as a working condition fringe benefit.

Deduction for Qualified Tuition and Related Expenses: This expires in 2005.

Hope Scholarship/Lifetime Learning Credits: These credits will continue, but those taking distributions from Coverdell Accounts or Qualified Tuition Plans will be ineligible for the credits in any year in which a distribution is taken.

Deductibility of Student Loan Interest: Deduction will be allowed only for the first 60 months of required repayments.

Conclusion

Although simply reading through these choices can be confusing and make one feel dizzy, careful analysis of a taxpayer's situation and the applicability of the various programs can make a difference. Proper planning can permit a student to borrow less cash for college, rather than start a career faced with a ruinous mountain of debt. It can also mean being able to finance a more expensive school than otherwise possible. Finally, it can mean that parents are left with more cash to devote to retirement savings. As these programs and others evolve, taxpayers and their advisors should remain vigilant.

While recent congressional action has been quite positive, the author hopes that Congress will take further action to consolidate, simplify and alleviate the uncertainty of these programs. ⚖

1. Often pronounced "egg terra" or simply "exasperating."
2. Unless otherwise stated, all deductions and rules apply to the 2002 tax year and beyond. Many of the rules have been liberalized and limits increased over prior tax years.
3. These programs are larded with complexity and are the subject of entire books.
4. All Code Sec. references are to the Internal Revenue Code of 1986, as amended. (26 USC 1, *et seq.*)
5. Many may find the opinion that parents are required to support their adult offspring to be cavalier, particularly in light of no such legal requirement. However, the College Board and others who administer need-based financial aid apply such standards. Their entrenchment and ubiquitousness in the financial aid process has given their standards the practical effect of law.
6. Code Sec. 529(b)(6).
7. Code Sec. 529(c)(3)(B)(ii).
8. Code Sec. 529(c)(3)(A).
9. At the time this article was written, the Colorado and Illinois plans were regarded as among the most worthwhile. However, new programs are being created on an almost monthly basis.
10. Code Sec. 529(c)(3)(C); Notice 2001-55, I.R.B. 2001-39.
11. Code Sec. 529(c)(2)(B).
12. Code Sec. 530(b)(1)(A).
13. Code Sec. 4973.
14. Code Sec. 530(c).
15. Code Sec. 530(b)(2).
16. Code Sec. 530(d)(C)(5).
17. Code Sec. 530(d)(4)(A).
18. Code Sec. 530(b)(2)(B).
19. Code Sec. 530(d)(2)(C)(i).
20. Code Sec. 530(b)(2)(A).
21. One possibility might be for the beneficiary to convert the Coverdell Account to the beneficiary's own Qualified Tuition Plan account.
22. Code 529(e)(5).
23. Code Sec. 135(c)(1). The unfairness of this restriction is illustrated as follows: A bond that was a gift from a family friend would not qualify if issued in a minor child's name, but had the bond been issued in the parents' name, it would presumably qualify.
24. Code Sec. 135(b)(2)(A); Rev. Proc. 2001-59, I.R.B. 2001-52.
25. Code Sec. 135(b)(2)(B).
26. Code Sec. 135(d)(3).
27. Code Sec. 135(d).
28. Code Sec. 117(b)(2).
29. Code Sec. 117(c).
30. Code Sec. 117(d)(2).
31. Code Sec. 117(d)(5).
32. Code Sec. 117(d)(2).
33. Code Sec. 117(d)(3).
34. As opposed to a member of the employee's family, for example.
35. Code Sec. 127(c)(1).
36. Code Sec. 127(b)(3).
37. Code Sec. 127(c)(7).
38. Code Sec. 2611(b)(1).
39. The consequences of the 2001 changes to and the potential for eventual repeal of the estate and generation-skipping transfer taxes should be evaluated as well.
40. Code Sec. 222(b). Married taxpayers must file jointly to claim this deduction.
41. Code Sec. 222(c).
42. Consisting of tuition and fees required for attendance. Code Sec. 25A(f)(1).
43. Code Sec. 25A(f)(1)(A).
44. Code Sec. 25A(b)(1).
45. Code Sec. 25A(c)(1).
46. Code Sec. 25A(g)(5). But, in the same year, Papa could claim a Hope Scholarship Credit for freshman Susie, a Lifetime Learning Credit for senior Fred, and a deduction for tuition expenses for Reginald, who is attending an expensive medical school.
47. Code Sec. 25A(g)(2).
48. Code Sec. 25A(g)(5).
49. Code Sec. 25A(d)(2).
50. Code Sec. 25A(h).
51. Code Sec. 221(b)(2)(B).
52. Code Sec. 221(f).
53. P.L. 99-514.
54. Code Sec. 163 (prior to the Tax Reform Act of 1986, P.L. 99-514).

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