related expenses for qualified higher education is deductible even if the taxpayer uses the standard deduction. The amount annually deductible is limited to $2,500.

Note: Student loan interest is not limited to government student loans and could be home equity loans, credit card debt, etc., provided the debt was incurred solely to pay qualified higher education expenses.

The annual deduction begins to phase out when modified AGI reaches the threshold amount and is fully phased out when the modified AGI reaches the top of the phase-out range. The phase-out ranges are inflation adjusted in $5,000 increments. For example, the 2019 range is between $70,000 and $85,000 for single taxpayers and between $140,000 and $170,000 for joint return filers. Please call this office for other years' phase-out levels.

EDUCATION TAX CREDITS

The law provides for two tax credits, the American Opportunity Tax Credit (AOTC) and the Lifetime Learning Credit, as explained later. Both credits will reduce a taxpayer's tax liability dollar for dollar until the tax reaches zero. Credit in excess of the tax liability is lost for the Lifetime Learning Credit, but 40% of the AOTC may be refundable. The credit is not allowed for taxpayers who file married separate returns.

The credits are elective, and the taxpayer must choose between the two credits for each student. In general, most taxpayers will find the American Opportunity Credit to be more beneficial in the initial years of college and then the Lifetime Credit for subsequent education.

The American Opportunity and Lifetime credits phase out when a taxpayer's modified AGI reaches a threshold amount and is fully phased out when the modified AGI reaches the top of the phase-out range. The phase-out amounts for 2019 for the Lifetime Credit , which are annually adjusted for inflation, are between $58,000 and $68,000 for unmarried taxpayers and $116,000 to $136,000 for jointly filing couples. The phase-out ranges for the American Opportunity Credit are fixed at $80,000 to $90,000 ($160,000 – $180,000 for a joint return). Please call this office for the Lifetime Learning Credit phase-out levels after 2019.

American Opportunity Tax Credit

The American Opportunity Tax Credit provides a credit for four years of college expenses, and the maximum credit per student is $2,500 per year. The credit is based on 100% of the first $2,000, and 25% of the next $2,000, of tuition, fees and course material (including books) expenses paid during the tax year. 40% of the credit is refundable, provided the taxpayer is not: (1) a child under the age of 18 or (2) under the age of 24, a full-time student and not self-supporting. As noted above, this credit begins to phase out for AGI in excess of $80,000 ($160,000 for married couples filing jointly). This credit can be used to offset the alternative minimum tax.

Lifetime Learning Credit

The Lifetime Learning Credit is a credit of up to 20% of the first $10,000 of qualifying educational expenses for: (1) undergraduate, graduate, or certificate level courses for a student attending classes on at least a half-time basis; or (2) any course at an eligible institution to acquire or improve job skills of the student (no attendance time requirements).

Example: A taxpayer has two children attending college on a full-time basis. The taxpayer pays qualified tuition expenses for the two children in the amount of $12,000, and there is no reimbursement or other tax benefit claimed for the tuition expense. Under the Lifetime Learning Credit rules, the taxpayer is entitled to a tax credit of $2,000 (20% of the first $10,000) for the tax year.

Qualifying expenses... for these credits include tuition and fees but not expenses for room, board, books, and other nonacademic fees such as student activity, athletic, insurance, etc. Also excluded are expenses for courses that involve sports, games, or hobbies that are not part of a degree program. Expenses qualifying for the credit must be reduced by tax-free scholarships or fellowships and other tax-free educational benefits. For years after 2015, books, supplies and equipment required for enrollment or attendance at an eligible institution are allowable expenses for the American Opportunity Tax Credit.

Qualifying students... must attend a qualified educational institution (one that is eligible to participate in U.S. Dept. of Education student aid programs). The student must be the taxpayer, his or her spouse, or someone who is a dependent of the taxpayer. In addition, in the case of the American Opportunity Credit, the student must have no federal or state felony drug convictions for the academic period to which the credit would apply.

SAVINGS BOND INTEREST EXCLUSION

Interest earned on U.S. savings bonds is, by federal law, excludable from taxation for state income tax purposes but taxable on the federal return. However, for certain savings bonds, an individual can even exclude the interest on the federal return. To qualify for this Federal exclusion, the bonds must be Series EE U.S. savings bonds issued after 1989, or Series I Bonds, and the bond proceeds must be used to pay higher education expenses.

Other qualifications... The bond purchaser must be age 24 or over and must be the sole owner of the bond (or, if married, joint owner with a spouse). Bonds purchased by others (except the spouse) or purchased by the taxpayer and placed in another's name do not qualify for the exclusion.

Redemption of bonds... When the bonds are redeemed, the interest earned is excludable from income to the extent the proceeds are used to pay qualified higher education expenses for the taxpayer, spouse, or any dependent of the taxpayer. Such expenses include tuition and fees but not room and board or courses involving sports, etc., that aren't part of a degree program.

Phase out... Like so many of the other education benefits described earlier in this brochure, the interest exclusion phases out when modified AGI is between certain inflation-adjusted limits. For 2019, the phase-out occurs between $81,100 and $96,100 for single taxpayers and between $121,600 and $151,600 for married taxpayers filing joint returns. For phase-out levels for other years, please call this office.

TAX BREAKS FOR HIGHER EDUCATION

CLIENT INFORMATION SERIES

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TAX BREAKS
FOR HIGHER EDUCATION

Over the years, Congress has continued to enhance tax breaks for students and their parents. These tax benefits provide taxpayers with a large number of options for tax-favored financing of their education and the education of their family members. This brochure highlights the various education benefits included within the U.S. income tax system.

- Coverdell Education Savings Account (Education IRA)
- Qualified State Tuition Program
- American Opportunity Credit
- Lifetime Learning Credit
- Penalty-Free IRA Withdrawals for Education Purposes
- Deduction for Education Loan Interest
- Tax-Free Savings Bond Interest

Student aid is available from the Department of Education for students of limited means. The aid can include educational grants such as a "Pell" grant or various types of student and parent educational loans. Planning and saving for future education can limit or eliminate potential student aid, because these resources will be taken into consideration at the time the need for student aid is determined.

Understanding the tax terms: You will encounter several tax terms in this brochure that may be unfamiliar to you. Understanding their full meaning will help give you a better picture of the limits, qualifications, and restrictions that apply to the benefits for education.

Phase Out... Instead of just eliminating certain deductions and credits, the tax law often decreases them gradually to zero ("phases them out") over a specific income range. For example, say a hypothetical $1,000 deduction is allowed, but "phases out" when a taxpayer's "modified adjusted gross income (AGI)" is between $40,000 and $60,000. A taxpayer with a modified AGI of $40,000 or less will be allowed the full $1,000 deduction, while the taxpayer with a modified AGI of $60,000 or more would get no deduction. For modified AGIs between $40,000 and $60,000, the taxpayer would be allowed a pro-rated deduction amount.

Regular AGI and Modified AGI... AGI is the abbreviation for "adjusted gross income." "Regular AGI" is the total of all income, allowable losses, and adjustments before subtracting itemized or standard deductions and, for years other than 2018 through 2025, personal exemptions. However, several tax benefits described in this brochure are limited or not available to taxpayers whose so-called "modified AGI" is too high. Generally, the modified AGI for educational benefits adds back certain amounts from foreign, U.S. Possession, and Puerto Rican sources that are excluded from income.

Qualified Educational Institutions... These Institutions are generally accredited, post-secondary educational institutions that offer credit toward a bachelor's degree, an associate's degree, or some other recognized post-secondary credential. Certain proprietary institutions and post-secondary vocational institutions also qualify if they are eligible to participate in Department of Education student aid programs.

COVERDELL EDUCATION SAVINGS ACCOUNT

Originally referred to as an Education IRA, the Coverdell Education Savings Account is actually a nondeductible education savings account. The investment earnings from this account accrue and are withdrawn tax-free if the proceeds are used to pay qualified education expenses of the account beneficiary.

Contributions are only allowed for designated beneficiaries under the age of 18 and the allowable nondeductible contribution is $2,000 per year per beneficiary.

The annual contribution limit is gradually reduced if the contributing taxpayer's "modified AGI" is within the phase-out range and eliminated for taxpayers above the range, which for married taxpayers filing jointly is $190,000 – $220,000 and $95,000 – $110,000 for single taxpayers. Unlike phase-outs for many other tax benefits, these amounts are not adjusted annually for inflation and have not changed since 2002.

Anyone is allowed to make the contribution provided the total contribution for the under 18 beneficiary does not exceed the annual contribution limit and the contributing taxpayer's AGI is within limits. If the AGI limits the contribution, the funds can be gifted to someone else whose contribution would not be AGI limited, even the beneficiary.

Distributions from the Coverdell Education Savings Account are tax- and penalty-free (including interest on the account) if they are used to pay for qualified education expenses of the designated beneficiary or a member of the beneficiary's family.

The definition of qualified education expenses includes elementary or secondary education, kindergarten through grade 12, as well as post-secondary education.

Because of the phase-out provision for contributions, taxpayers cannot always be sure they can contribute to the accounts. Recognizing this problem, the tax law permits Coverdell contributions to be made after the close of the tax year for which the contribution is being made and before the April 15 filing due date for that year. (Note: if the April 15 due date falls on a Saturday, Sunday or holiday, the due date is the next business day.)

Additional rules apply for dealing with rollovers, changes in designated beneficiaries, death of taxpayer or beneficiary, excess contributions, special needs beneficiaries, and unauthorized use of distributions.

QUALIFIED STATE TUITION PROGRAMS

A qualified state tuition program is one generally set up by a state or state instrumentality that lets individuals make contributions to an account established for a designated beneficiary's higher education.

Unlike the Coverdell Education Savings Account, there is no limit on the annual contributions to Qualified State Tuition programs. However, contributions to these plans are considered gifts to the beneficiary, making the annual gift exclusion amount the practical annual limit per contributor. The annual gift exclusion amount is inflation-adjusted periodically and is $15,000 for 2019; please call this office for the limit for other years. A special rule allows a donor who makes total contributions exceeding the annual gift limit to elect to take the contributions into account ratably over a five-year period, starting with the year of the contribution. This allows a donor to contribute as much as $75,000 (2019) in one year, while avoiding the gift tax implications. The donor must file a gift tax return for the year of the contribution, and a five-year election must be made on the return. Care should be exercised in determining the total contributed to any individual's account to avoid nonqualified distributions if the amount exceeds the educational needs.

Virtually all of the high population states now have these programs, which are professionally managed and tailor the investments and risk potential to the prospective student's current age. Individuals are not restricted to using the program established in their home state but instead can pick and choose among the programs of any of the states that have established programs.

A major benefit of these programs is that the distributions of earnings from the programs can be excluded from income if used for qualified education expenses. This puts the Qualified State Tuition Programs on par with Coverdell Education Savings Accounts, but without the annual contribution limit. However, unlike Coverdell plans that allow tax-free distributions to pay for grades K-12 expenses, distributions through 2017 from QSTPs were only used for post secondary education expenses.

For years after 2017, tax reform added withdrawals for elementary or secondary school tuition expenses but limits the annual withdrawal for each beneficiary to $10,000 (regardless of the number of 529 plans in the beneficiary's name). This special $10,000 amount applies for tuition paid to public, private or religious schools.

Additional rules apply for designated beneficiaries, death of taxpayer or beneficiary, and unauthorized use of distributions.

PENALTY-FREE IRA WITHDRAWALS

Generally, when funds are withdrawn from an IRA before a taxpayer reaches age 59, a 10% early withdrawal penalty applies to the distribution. However, penalty-free IRA withdrawals are permitted if the funds are used to pay qualified higher education expenses. The withdrawals will still be subject to regular income tax.

Qualified "higher education expenses" include tuition at a qualified educational institution, as well as related room, board, fees, books, supplies, and equipment. The expenses can be for the taxpayer, his or her spouse, or taxpayer's or spouse's children and grandchildren.

DEDUCTION FOR INTEREST

Generally taxpayers can only deduct home mortgage interest, investment interest, and business interest. However, interest paid on student loans used to pay tuition, room and board, and