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EDUCATION INCENTIVES - COLLEGE FINANCIAL AID

(HOPE Scholarship - Lifetime Learning Credit/Higher Education Deduction/Education IRAs/Qualified Tuition Programs/Student Loan Interest Deductions)

- I. **Background.** Before TRA 97, income tax assistance was limited for students (or older individuals) who continued their education immediately after high school or prepared themselves for a new line of work without the aid of employer-provided reimbursement. The following tax incentives are currently provided for educational expenses.
- (A) **IRC §162.** The cost of education that **maintains or improves a skill** required in the taxpayer's current line of business or meets express employer or legal requirements is deductible by the taxpayer as a business expense.
 - (B) **IRC §127.** Employees can exclude up to \$5,250 annually for **undergraduate course (also graduate courses after 2001)** education expenses paid under a qualified employer-provided educational assistance program.
 - (C) **IRC §135.** The **interest** earned on U.S. Series EE bonds (issued after 1989) and Series I bonds is **excluded from income** (Form 8815) provided that the bond proceeds are used to pay **higher education tuition and fees (not room and board)** and subject to AGI phase-out limits.
 - (D) **IRC §117.** Degree candidates can exclude qualified scholarships used for **tuition and fees (but not room and board)** at any primary, secondary or post-secondary educational institution.
 - (E) **IRC §25A.** Amounts paid for higher education **tuition and fees (but not room and board)** are eligible for income tax credits (Hope and/or Lifetime Learning credits) subject to AGI phase-out limits.
 - (F) **IRC §530.** The **earnings and distributions** from amounts paid into Coverdell Education Savings Account (CESA)/(Education IRA) are **tax-free** as long as they are **utilized for "qualified higher education expenses"** which can include **basic room and board (also K-12 educational expenses after 2001)**. Contributions to these accounts are subject to AGI phase-out limits.
 - (G) **IRC §529.** The **earnings** from amounts paid into qualified tuition programs (pre-paid tuition programs and/or savings plans) are tax-deferred until distribution; and, at distribution, become **tax-free** under rules similar to Coverdell Education Savings Account (CESA)/(Education IRAs). **Distributions can be utilized for room and board.**
 - (H) **IRC §221.** **Interest expense on qualified educational loans** is allowed as a **deduction for AGI** (above-the-line) up to specified dollar limits and subject to AGI phase-out limits.
 - (I) **IRC §222.** For tax years beginning after 2001, **qualified tuition and related expenses** may be deducted for AGI (above-the-line) in lieu of the Hope Scholarship and Lifetime Learning credits, up to specified dollar limits and subject to AGI limitations.
 - (J) **IRC §108(f).** A student can exclude discharge of indebtedness income resulting from the forgiveness of certain student loans if the forgiveness was contingent on the student working for a certain period in stipulated professions.

The following paragraphs provide an in-depth analysis of selected educational incentive provisions following EGTRRA of 2001.

- II. **Employer-Provided Educational Assistance -- IRC §127.** The **exclusion** (up to \$5,250 per calendar year) for employer-provided educational assistance **for undergraduate courses** was **made permanent** by the EGTRRA of 2001. In addition, the **exclusion** was **extended to graduate courses for tax years beginning after 2001.** IRC §127(c).

Expenses paid by an employer for courses are excludable from the employee's wages and gross income if the expenses qualify as a working class fringe benefit under IRC §132. **Eligible expenses include tuition, fees and related expenses, books, supplies and equipment.**

NOTE: Not more than 5% of the amount paid by an employer for educational assistance can be provided to shareholders or owners who own more than 5% of the business or to spouses or dependents of those shareholders or owners. IRC §127(b)(3).

- III. **Hope Scholarship Credit (Hope Credit)/Lifetime Learning Credit (Form 8863).**

- (A) **Credit Amounts.** For 2008-2009, the **Hope credit provides a maximum allowable credit of \$1,800 per student, per year** (100% of the first \$1,200; 50% of the next \$1,200) for "qualified tuition expenses" for each of the **first two years** of post-secondary education. The Hope credit cannot be claimed if the student has completed two years of higher education before the **beginning** of the current tax year. IRC §25A(b)(2)(C).

For tax years beginning on or after January 1, 2003, The **Lifetime Learning credit allows a credit of 20% for the first \$10,000 (up to \$2,000 per year) per taxpayer return, per year**, of "qualified tuition expenses" paid by the taxpayer **for any year the Hope credit is not claimed with respect to the same student's tuition.** Thus, the Lifetime Learning credit is also available for the first two years of post-secondary education if its use is elected in lieu of claiming the Hope credit for educational expenses incurred during this time frame. The Lifetime Learning credit is available for **both undergraduate and graduate-level courses.**

TAX PLANNING: For 2008-2009, the Lifetime Learning credit will exceed the Hope credit if tuition and fees exceed \$9,000 (\$9,000 x 20% = \$1,800).

TAX PLANNING: The Lifetime Learning credit is **per taxpayer**, not per student, and does not vary with the number of students in a family. Additionally, it can be claimed for an unlimited number of years and applies for both undergraduate and graduate courses.

RELATION TO ALTERNATIVE MINIMUM TAX (AMT): Both credits are **non-refundable credits which can reduce regular tax liability and are eligible to be used against alternative minimum tax (AMT).**

- (B) **Eligible Student (Degree and Workload Requirement - Hope Credit Only).** An individual enrolled in a degree or certificate program at an eligible educational institution who carries at least one-half of a normal full-term work load (e.g. 6 credit hours; full-term = 12 credit hours).

NOTE: The requirement that the student carry at least one-half of a normal full-term workload only applies for the Hope credit. The Lifetime Learning credit may be claimed for any course at an eligible educational institution that helps an individual acquire or improve job skills (e.g. continuing education credits and non-credit professional seminars provided at eligible educational institutions).

- (C) **Midwest Disaster Area - Doubling of Hope/LLC Credits for 2008 and 2009.** Applicable for all counties declared eligible for disaster assistance (only federally declared disaster counties) in AR, IL, IN, IA, KS, MI, MN MO, NE and WI, as declared by FEMA on or after May 20, 2008 and before August 1, 2008.

Hope and Lifetime Learning Credits are doubled and the definition of what can be included as "qualified tuition expenses" is expanded for individuals who **attend (are enrolled at) an eligible educational institution located in a county within the Midwestern federally declared disaster area** in any tax year beginning in 2008 and 2009.

Credit Amounts. The doubled Hope Credit is 100% of the first \$2,400 of qualified tuition and related expenses and 50% of the next \$2,400 of qualified expenses, for a maximum Hope credit of \$3,600 per student. The Lifetime Learning credit is 40% of up to \$10,000 of qualified expenses for a maximum of \$4,000 per taxpayer return, per year. IRC §14000.

NOTE - EXPANDED DEFINITION OF QUALIFIED TUITION EXPENSES: For students who attend eligible institutions located in the Midwest disaster area in 2008-2009, the definition of "qualified tuition and related expenses" is expanded to include room and board expenses, and any other costs which are eligible qualified higher education expenses for tax-free IRC §529 plan reimbursements (books, supplies, equipment, fees for special services, etc.). See IRC §14000(1) and §529(e)(3). This additional break only applies to students who carry at least one-half of a normal full-term workload (e.g. 6 credit hours; full-term = 12 credit hours).

- (D) **Year of Study Requirement (Hope Credit Only):** A student is eligible for the Hope Credit if at the **beginning of the tax year, a student has completed less than two years of post-secondary education.** IRC §25A(b)(2)(C). The test of whether a student has completed two years of post-secondary education is based on academic credit awarded by the institution for coursework completed by the student prior to the beginning of the tax year. **Academic credit awarded by the institution solely on the basis of the student's performance on proficiency examinations is disregarded.** IRC Regs. §1.25A-3(d)(1)(iii).

EXAMPLE: Monica graduated from high school in May, 2008. During her high school years, she took courses at a local junior college for which she received college credits. Monica enrolled at the University of Iowa for the 2008 fall semester classified as a second semester sophomore based on the college credits she had received during her high school years.

Monica is an eligible student for the Hope Credit in 2008 because she had completed less than 2 years of post-secondary work at the beginning of 2008. Because Monica was **enrolled in a degree program** at her local junior college, any qualified expenses paid for courses she took in the spring of 2008, while in high school, would be eligible for the Hope Credit, as well as, the expenses for courses she took at the U of I in the fall of 2008.

NOTE: See IRC Regs. §1.25A-3(d)(2), Example (4) for an illustration involving academic credit and advanced placement awarded by an institution on the basis of a student's performance on proficiency examinations. In this example, academic credit was

not awarded by an institution for **coursework completed**, the student was merely classified as a second semester sophomore based on proficiency exams. Therefore, the Hope Credit was still available for the student's first 2 years of college study.

Since a student's academic status is determined at the beginning of a tax year, if the student has not achieved junior standing as of January 1st, tuition for the **entire** calendar year can count as an eligible expense for purposes of the Hope credit. The student's **year-of-study status** depends on his or her standing at the current institution. **When a student has studied at another school, only credits that are successfully transferred to the new school are counted in determining the student's year-of-study status at the new school.**

NOTE: If a student meets the half-time requirement for one academic period during the year, the tuition for other periods during the year (when this requirement is **not** met) still counts as an eligible expense for Hope credit purposes. IRC Regs. 1.25A-3(d)(2), Example 1.

NOTE: If a student enrolls in college but quits before the semester is completed, a Hope or Lifetime Learning credit may still be claimed. Apparently, while expenses must be paid for "**attendance**" at a qualified institution, there is **no requirement** that the courses be **completed**. IRC §25A(f)(1)(A).

NOTE: A student who completes a one-year post-secondary certificate program and in a later year completes another one-year post-secondary certificate program may claim a Hope credit for both years. IRC Regs. §1.25A-3(d)(2), Example (9).

EXAMPLE: Mary enrolls as a half-time (6 hours) student at UNI in the fall of 2007. In 2008, she is a full-time student for the spring semester but takes only one class during the fall. In 2009, she takes a full course load all year, including summer courses to complete her sophomore year. Mary's tuition for all three years will count as an eligible expense for the Hope credit since she had not completed 2 full years of academic work as of January 1, 2009. The only limitation for Mary is that the Hope credit can be claimed in **only two** of the three years.

- (E) **Qualified Tuition and Related Expenses:** Both credits are available for qualified **tuition and related expenses (not room, board or books)** incurred for the **taxpayer, the taxpayer's spouse, or the taxpayer's dependent** at an eligible educational institution. IRC §25A(f)(1). Thus, charges and fees associated with room and board, student activities, athletics, insurance, transportation, and personal or living expenses do **not** qualify.

NOTE - BOOKS, SUPPLIES, ETC.: IRC Reg. §1.25A-2(d)(2) provides that charges and fees associated with books, supplies, and equipment qualify if the fee **must** be paid to the eligible educational institution **as a condition of the enrollment or attendance** of the student at the institution (e.g. not acquired from off-campus sources).

- (F) **Eligible Education Institution:** These institutions generally are accredited post-secondary educational institutions (including certain vocational schools) offering credit for a bachelor's degree, an associate's degree, or another recognized post-secondary credential. The institution must be eligible to participate in Department of Education's student aid programs. IRC §25A(f)(2).
- (G) **Credit Available in Tax Year Expenses are Paid:** Both the Hope credit and the Lifetime Learning credit are available in the tax year the expenses are paid, so long as the education commences or

continues for at least one academic period during that year, **or during the first three months of the next tax year.** IRC §25A(b)(2)(B) & (G)(4). If qualified tuition expenses are paid with the proceeds of a loan, they will still be eligible for these credits in the year the tuition is paid (not in the year the loan is repaid). Thus, prepaying tuition can assure that the full \$2,400 of eligible expense is paid in the 2008 or 2009 tax year so that the full \$1,800 Hope credit can be claimed for that year.

EXAMPLE: In December, 2008, Monica pays qualified tuition and related expenses to State College for the second semester of her freshman year beginning January 15, 2009. Monica can claim either the Hope credit or the Lifetime Learning credit (but not both) on her 2008 return, based on the payment of the expenses in 2008, since the education begins during the first three months of the following year, 2009. Had Monica paid the expenses in January, 2009, she would claim the credit in the 2009 tax year.

- (H) **Reduction of Qualified Expenses:** Only net out-of-pocket costs will be considered as qualified tuition and related expenses for purposes of claiming the Hope credit and Lifetime Learning credit. Thus, eligible expenses are reduced by any amounts (allocable to the tax year) that were paid for the benefit of the student. IRC §25A(g)(2) reduction items are as follows:
- (1) Qualified scholarships/fellowships excludable from gross income under IRC §117;
 - (2) Qualified expenses used to compute tax-free withdrawals from IRC §529 plans and/or Coverdell Education Savings Accounts;
 - (3) Qualified expenses used to compute the interest exclusion for U.S. Savings Bonds;
 - (4) Any other payment (other than a gift, bequest, devise or inheritance) that is excludable from gross income and is not required to be repaid;
 - (5) Veteran's educational assistance allowance or educational assistance allowance for members of the selected reserve;
 - (6) Amounts covered under an employer-paid educational assistance program which have been excluded from income; **and**
 - (7) Amounts deducted as business expenses.

TAX PLANNING: Neither the Hope credit nor Lifetime Learning credit are reduced by any educational expenses paid by gift, bequest, devise or inheritance. **Also, if a student who is a dependent personally pays tuition related expenses, the amounts are treated as paid by the parents for purposes of the credit calculations.** If a third party pays tuition costs for a student, the tuition is treated as if paid by the student, and consequently the student's parents, if the student qualifies as a dependent. IRC Regs. §1.25A-5(a)&(b).

- (I) **Interaction of Credits -- Additional Limitations:** For tax years beginning before 2002, a taxpayer was permitted to elect only one of the following with respect to a student:
- (1) The Hope credit;
 - (2) The Lifetime Learning credit; **or**
 - (3) The exclusion for distributions from CESA (Education IRA) used to pay higher education costs.

Also, the amount of qualified higher education expenses taken into account for purposes of the interest exclusion on U.S. Series EE or I savings bonds (IRC §135) is required to be reduced by the amount of the expense that is taken into account in computing either the Hope credit or the Lifetime Learning credit.

NOTE - 2002 TAX LAW CHANGE: For tax years beginning after 2002, taxpayers are allowed to take tax-free withdrawals from a CESA (Education IRA) in the same year a Hope or Lifetime Learning credit is claimed with respect to a student, as long as, different expenses are applied to offset each educational incentive.

NOTE: Under current law, the Hope and Lifetime Learning credits can be claimed in the same year that a distribution from a qualified state tuition program (IRC §529 Plan) is received by the student as long as the QSTP distribution and the Hope or Lifetime Learning credits are applied to different expenses.

TAX PLANNING: Because the various education incentive elections are separately applied for each student, parents can mix and match their elections if they have more than one eligible child. For example, the parents could claim the Hope credit or Lifetime Learning credit for one child; and the exclusions for distributions from a CESA (Education IRA) for another. Also, they could elect to take the Hope credit for one child and the Lifetime Learning credit for another child.

For tax years beginning after 2001, CESA (Education IRA) or QSTP distributions could be elected to offset room and board expenditures, while Hope and/or Lifetime Learning credits offset tuition and related expenses.

- (J) **Phase-out of Hope Credit and Lifetime Learning Credit:** Both of these credits are phased-out pro-rata over a range of modified AGIs (generally AGI increased by the foreign earned income exclusions), as follows:

<u>FILING STATUS</u>	<u>2008 PHASE-OUT RANGE</u>	<u>2009 PHASE-OUT RANGE</u>
MFJ returns	\$96,000 - \$116,000	\$100,000 - \$120,000
Single/HOH	\$48,000 - \$ 58,000	\$ 50,000 - \$ 60,000
Married filing separate	Not allowable	Not allowable

NOTE: Neither credit is available to married taxpayers filing separately. However, taxpayers who are considered unmarried under head of household rules (e.g. lived apart for last 6 months of the tax year, etc.), are also considered unmarried for the Hope and Lifetime Learning Credit. IRC Regs. §1.25A-1(h).

NOTE: The AGI ranges for the phase-out of the credits are indexed for inflation in multiples of \$1,000 starting in the year 2002.

EXAMPLE: Jennifer and Lance file a joint return and claim Dave as a dependent. Wages of \$100,000 are their only income source. Dave starts college in 2008 and incurs out-of-pocket tuition and fee expenses of \$5,000. Jennifer and Lance elect to use the Hope credit on their 2008 return. Eligibility for the Hope credit is \$1,800 before considering the AGI limitation. Since Jennifer and Lance are \$4,000 into the \$20,000 phase-out range for joint filers, their Hope credit for the 2008 tax year is limited to \$1,440 (($\$20,000 - \$4,000$) ÷ $\$20,000 = (80\% \times \$1,800)$).

If Jennifer and Lance had elected to claim the Lifetime Learning credit, they would be eligible to claim a credit of \$800 (($\$20,000 - \$4,000$) ÷ $\$20,000 = (80\% \times \$1,000)$).

NOTE: In the alternative, Jennifer and Lance could claim a \$4,000 higher education deduction under IRC §222; however, the tax benefit from this deduction would only equal \$1,000 ($\$4,000 \times 25\%$ marginal tax bracket).

TAX PLANNING: Families that have modified AGI in excess of the phase-out levels may want to consider having the student claim the Hope/Lifetime Learning credit himself if his modified AGI is not above the phase-out limits. Otherwise, the taxpayers may want to accelerate income (salary bonuses, etc.) or decelerate income (deferred compensation, etc.) in certain tax years to avoid application of the phase-out rules. **Taxpayers may also wish to consider contributing to a traditional IRA (if eligible) to lower modified AGI.**

- (K) **Which Taxpayer Claims the Credit?** To claim either the Hope credit or the Lifetime Learning credit for a child, the parents **must claim the student as a dependent**. However, even if parents paid more than one-half of a child's support, and are therefore eligible to claim the child as a dependent for the tax year, they can **elect not to claim a dependency exemption**. This would allow the child to claim the benefits of the Hope or Lifetime Learning credit on his own return.

NOTE: The child would not be able to claim a personal exemption deduction for himself since he did **not personally pay more than one-half of his support during the tax year**. IRC Regs. 1.25A-1(g). See also: CCA 200236001.

TAX PLANNING: The "family" tax benefit gained by allowing the child to claim the Hope/Lifetime Learning credit must be weighed against the "family" tax detriment of the parents giving up the dependent exemption deduction. The fact that the parents fail to claim a personal exemption deduction for the child that is rightfully theirs does not entitle the child to a dependency deduction of his own. The child is either a dependent or not.

NOTE: If the parents' AGI is high enough to be affected by the phase-out for personal exemption deductions, the tax detriment may be minimal or nonexistent.

TAX PLANNING - MARRIAGE DISSOLUTION: Since both the Hope credit and Lifetime Learning credit are only available to the parent who **both pays the tuition and is allowed to claim the student as a dependent**, divorced parents may want to avoid situations where one parent pays the tuition and the other claims the child as a dependent under a support agreement. **The parent claiming the dependent will be the only parent allowed to claim the credit. The tuition paid by the other parent will be deemed to have been paid by the dependent; and, thus, the parent claiming the dependency deduction.** IRC Regs. §1.25A-5(b)(3), Example (2).

- (L) **Additional Rules:** Several additional provisions apply to the Hope credit and Lifetime Learning credit:
- (1) **Felony Possession/Distribution of Controlled Substance.** The Hope credit is not allowed for any year in which a student is convicted of a felony for the possession or distribution of a controlled substance. **There is no such prohibition for the Lifetime Learning credit.**
 - (2) **Inflation Adjustment.** The eligible Hope credit tuition amounts (\$1,000 initially for each credit test) are adjusted for inflation in multiples of \$100 for tax years starting in 2002. **NOTE: For 2008-2009 the maximum allowable Hope credit will be \$1,800 (100% of the first \$1,200 of "qualified tuition expenses" and 50% of the next \$1,200).** There is no comparable inflation adjustment provided for the Lifetime Learning credit amount \$10,000 (\$5,000 prior to 2003).

EXAMPLE 1: Assume taxpayers file a joint return and claim Beth as a dependent. Taxpayer's modified AGI is \$80,000. Beth starts her freshman year in September, 2008 at a qualified educational institution. Her tuition and fees are \$7,200. Beth pays \$1,000 of the tuition from her funds; her parents (taxpayers) pay \$6,200. Taxpayers may claim a Hope Credit of \$1,800 or a Lifetime Learning Credit of \$1,440, but not both. (Higher Education Deduction = \$1,000 (\$4,000 x 25% marginal tax bracket)).

Taxpayers may also claim the Hope Credit in 2009, during Beth's second year of college. Assuming similar expenses and income, if the taxpayers claimed the Hope Credit in both 2008 and 2009, they may only claim a Lifetime Learning Credit (or Higher Education Deduction) in the year 2010 and following years regardless of Beth's academic status, since the Hope Credit may only be claimed for 2 years.

EXAMPLE 2: Assume the same facts as above, but taxpayers' modified AGI is \$116,500 in 2008. Taxpayers may **not** claim either a Hope Credit or Lifetime Learning Credit. (Higher Education Deduction = \$1,000 (\$4,000 x 25% marginal tax bracket)).

EXAMPLE 3: Assume taxpayers (in Example 1) not only have Beth in school in 2008, but also a second daughter, Melissa. Neither have completed two years of education. Assume Melissa's qualified tuition and fees total \$3,600. Taxpayers may claim a \$1,800 Hope Credit for Beth and a \$1,800 Hope Credit for Melissa (\$3,300 total), but may not claim more than a \$2,000 Lifetime Learning Credit for the year. (Higher Education Deduction = \$1,000 (\$4,000 x 25% marginal tax bracket) for one or both students. See discussion for Higher Education Deduction below).

EXAMPLE 4: Assume Kevin is an single attorney, who is taking classes at a local college in computer operation. Assume further, he spends \$1,200 for tuition and fees in 2008. Kevin is not eligible for the Hope Credit, but should qualify for a \$240 Lifetime Learning Credit (even though he does have a felony controlled substance conviction), and because it is doubtful that an attorneys income will exceed the phase-out thresholds.

TAX PLANNING NOTE: As an alternative in Example 4 above, if Kevin is self-employed, he might also consider claiming an expense deduction under IRC §162 on his Schedule C for the cost of the computer classes, in lieu of the Lifetime Learning Credit. This deduction should be more valuable than the Lifetime Learning Credit considering marginal federal and state income tax rates and self-employment tax effects.

(M) **TAX REPORTING -- Form 8863, Education Credits (Filing Requirements/Amended Returns):** Individuals can claim both the Hope and Lifetime Learning Credits on timely filed original returns or on amended tax returns within the three-year statute of limitation time frame. Notice 99-32, 1999-23 IRB 6.

(N) **TAX REPORTING -- Reporting of Qualified Tuition and Related Expense Refunds:** If a taxpayer receives a refund of qualified tuition and related expenses for which an education credit was claimed in a prior year, he or she must increase tax liability reported on Form 1040 for the year in which the refund was received by the amount of excess Hope or Lifetime Learning Credit claimed. IRC Regs. §1.25A-5(f)(3). This procedure also applies to a student receiving excludible education assistance for qualified tuition or related expenses paid in a previous year. In this situation, the educational assistance will also be treated as a refund of the qualified tuition or related expense.

NOTE: Hope and Lifetime Learning Credit recaptures are included as additional taxes on Form 1040 (for 2008 the entry would be made on line 44, denoted "ECR").

IV. **Higher Education (Tuition and Fees) Deduction (Form 8917) - IRC §222.** For tax years beginning after 2001, individuals were given the option of claiming a "for AGI" (above-the-line) deduction for qualified tuition and related expenses **in lieu of** the Hope or Lifetime Learning credit. Eligible tuition and related expenses are those expenses eligible for the Hope and Lifetime Learning credits, paid for individuals eligible for those credits (e.g. taxpayer, spouse, dependents), and generally subject to similar rules and restrictions provided for said credits.

(A) **Maximum Reduction Amount:** For 2004 and after, the maximum deduction amount increased to \$4,000. For 2002 and 2003, the higher education deduction amount could not exceed \$3,000 subject to modified AGI limitations.

NOTE: A lower \$2,000 maximum deduction is also available for 2004 and after at higher modified AGI limits. (See phase-out table below).

NOTE: The tuition and fees deduction is not available to married taxpayers filing separately, and is not available to an individual with respect to whom a dependency exemption is allowable to another taxpayer for the tax year. IRC §222(c)(3)..

(B) **Modified AGI Deduction Limits:** Modified AGI = (AGI computed without the tuition and fees deduction and increased for the foreign income exclusion and domestic production activities deduction). The following table summarizes the deduction limitations.

(C) **NOTE - CLIFF RULE:** There is no phase-out range.

Qualified Higher Education Expenses (Modified AGI Deduction Limits)			
Year	Single/HOH	Married Filing Jointly	Maximum Deduction
2002-2003	\$0-65,000	\$0-130,000	\$3,000
2004-2005	(A) \$0-65,000	\$0-130,000	\$4,000
	or (B) \$65,001-80,000	or \$130,000-160,000	or \$2,000

NOTE - NO DOUBLE BENEFITS: Taxpayers are not eligible to claim the tuition and fees deduction and a Hope or Lifetime Learning credit in the same year with respect to the same student. Also taxpayers cannot take tax-free CESA (Education IRA) or tax-free qualified tuition program (QTP) payments for college expenses and then claim a deduction for those same expenses. **However, taxpayers are not precluded from claiming a tuition and fees deduction for the amount of a distribution from a qualified tuition program (QTP) that is not attributable to earnings (e.g. return of contribution).**

Similarly, college expenses used to compute tax-free interest from U.S. Savings Bond and other nontaxable payments received for educational expenses (e.g. veteran's benefits or employer-provided educational assistance) are not eligible to be utilized in calculating a tuition and fees deduction.

(D) **TAX PLANNING CAUTION - NO "DEEMED PAID" RULE FOR TUITION AND FEES DEDUCTION:** Unlike the Hope and Lifetime Learning credit "deemed paid" rules, the tuition and fees deduction is calculated using only those educational expenses **paid by the taxpayer and/or spouse**. IRS Pub. 970. In order to claim the tuition and fees deduction for qualified education expenses for a student/dependent, the taxpayer(s) must have:

- (1) Paid the expenses; and
- (2) Claim an exemption for the student as a dependent

If a taxpayer is eligible to claim a dependency exemption on his return for a student, and the **student paid the tuition expenses himself, no one is allowed to claim** the tuition and fees deduction. Similarly, any educational expenses paid to or for the student by a third party (i.e. grandparent, former spouse, other relative, etc.), are treated as **paid by the student**, so that a parent/spouse **could not** claim these expenses on their return.

EXAMPLE: Sam is an undergraduate student at Iowa State University. His qualifying tuition and fees expense for the current tax year totaled \$8,000. If Sam can be claimed as a dependent on his parent's return, who is eligible to claim the tuition and fees deduction (and in what amount) in the following scenarios?

Qualified Tuition/Fees Expense	Who is Eligible to Claim Tuition/Fees Deduction?	Maximum Amount
Sam pays: \$5,000 Parents pay: 3,000	Parents	\$3,000
Sam's grandfather pays: \$6,000 Sam pays: 500 Parents pay: 1,500	Parents	\$1,500

TAX PLANNING NOTE: In the above scenario, Sam's grandfather could provide a gift of the tuition and fees amount to Sam's parents, who would then pay the expense for Sam. The parents would then be eligible to claim the maximum tuition and fees deduction based on paying \$7,500 of Sam's tuition and fees.

If a taxpayer is eligible to claim a dependency exemption for a student, but does **not** do so, **no one** is allowed to claim the tuition and fees deduction. This applies whether the expenses are paid by the taxpayer or paid by the student.

When a taxpayer/parent **is not eligible** to claim such a dependency exemption for a student, any educational expenses paid by the taxpayer (or another party) are treated as a gift to the student. The student can then use all qualified educational expenses in calculating the tuition and fees deduction to be claimed on the student's return.

TAX PLANNING - TUITION AND FEES DEDUCTION VS. HOPE/LIFETIME LEARNING CREDIT: Taxpayers with AGI income below the range where the Hope or Lifetime Learning credits fully phase out, must compare the available credit with the tuition and fees deduction to determine which provides the highest tax benefit. Note that only \$4,000 of tuition qualifies for the tuition and fees deduction for 2004 and after (\$3,000 for 2002/2003), whereas up to \$10,000 (\$5,000 for 2002 and prior) of tuition qualifies for the Lifetime Learning credit. The tax benefit result will be determined from the following:

- (1) The amount of eligible tuition paid;
- (2) The marginal tax rate producing benefit from the deduction; and
- (3) The potential phase-out of the credit.

To add complexity to the decision, **claiming a tuition and fees deduction before calculating AGI could produce other tax savings on Form 1040 due to provisions that phase-out or phase-in based on AGI thresholds.**

State income taxes may also be a factor. In many states, a before-AGI tuition deduction also reduces state taxable income. A federal education credit is of no benefit on the state return.

TAX PLANNING NOTE: A taxpayer is not allowed to claim the tuition and fees deduction in the same year a Hope/LLC is claimed for the same student. Accordingly, parents with two students in college could claim up to \$4,000 (\$3,000 for 2002/2003) of total tuition for both students, but no Hope/LLC for either. On the other hand, if a Hope/LLC was claimed for one student, a deduction of up to \$4,000 (\$3,000 for 2002/2003) of tuition for the other student is allowable.

- (E) **TAX REPORTING -- Reporting of Qualified Tuition and Related Expense Refunds:** If a taxpayer receives a refund of qualified tuition and related expenses for which a tuition and fees deduction was claimed in a prior year, he or she must increase taxable income reported on Form 1040 for the year in which the refund was received by the amount of the excess tuition and fees deduction claimed. The excess tuition and fees deduction is reported as "Other Income" (Form 1040, line 21).

NOTE - EXTENSION OF PROVISION: Congress extended this provision under the Emergency Economic Stabilization Act of 2008. It will now expire January 1, 2010 unless further extended by Congress.

V. **Coverdell Education Savings Accounts - CESA/(Education IRAs) -- IRC §530.**

- (A) **General Provisions:** A CESA (Education IRA) is a trust (or custodial account) to be used exclusively for paying the "qualified higher education expenses" of a designated beneficiary. In many respects, the "IRA" label is a misnomer, as CESA (Education IRAs) are mutually exclusive from any other IRAs, in that no part of a CESA (Education IRA) is associated with retirement.

Up to \$2,000 (for tax years after 2001) per beneficiary, per year, may be contributed to a CESA (Education IRA) for a beneficiary under age 18. Any contribution will be non-deductible, but earnings and distributions from a CESA (Education IRA) generally will be tax-free, as long as they are utilized for "qualified education expenses". **The contribution limit is per beneficiary, not per tax return. The contribution limits will not be indexed for inflation.**

EXCEPTION FOR SPECIAL NEEDS BENEFICIARY -- 2002 TAX LAW CHANGE:

The age 18 limit on contributions is waived with regard to contributions for special needs beneficiaries for tax years beginning after 2001. A special needs beneficiary is defined as an individual who because of a physical, mental or emotional condition requires additional time to complete his or her education.

TAX PLANNING: No limitations exist on who can contribute to a CESA (Education IRA) on behalf of a designated beneficiary (other than the modified AGI phase-out limitations). Also, a designated beneficiary is not required to be the child of the contributor. Accordingly, it is possible that any relative, friend, or even the designated beneficiary could establish and contribute to a CESA (Education IRA).

NOTE: Contributions can be made to a CESA (Education IRA) account for a designated beneficiary **even if the contributor has no earned or taxable income**. Teenage or younger individuals might be encouraged to set-up their own CESA (Education IRA).

Deadline for Contributions -- 2002 Tax Law Change: For tax years beginning in 2002 and after, the deadline for contributions has been extended to the due date of the taxpayer's return (without extension) (e.g. April 15th for calendar year taxpayers).

Gift Tax Considerations: Contributions to a CESA (Education IRA) are treated as completed gifts of a present interest. Thus, contributions are eligible for the current \$12,000 annual gift exclusion (\$13,000 for 2009 and after), and are excludable for purposes of the GST tax.

CAUTION: Parents/grandparents need to coordinate so that total contributions for the same individual in the same tax year do not exceed \$2,000.

TAX PLANNING: A contribution of \$2,000 each year from the date of the child's birth to attainment of age 18 should result in a balance of \$72,000 to \$108,000 assuming growth rates between 8% and 12%.

Excess Contributions: Aggregate contributions in excess of \$2,000 per beneficiary, per year (by a contributor or group of contributors), are treated as excess contributions. If the excess contributions (and any earnings attributable to them) are not withdrawn from the CESA (Education IRA), by a contributor, before the 1st day of the sixth month of the year following the contribution year (June 1st), the excess contributions will be subject to a 6% excise tax for each year the excess amount remains in the account. IRC §4973(e). Any penalty is reported on Form 5329.

NOTE: Earnings on excess contributions, while exempt from the 10% early withdrawal penalty, are still subject to income taxation.

- (B) **Contribution Phase-out Limits:** The ability to contribute to a CESA (Education IRA) is phased-out pro-rata over a range of modified AGIs (generally AGI increased by the foreign earned income exclusion), as follows:

FILING STATUS	PHASE-OUT RANGE (2002 and after)
MFJ	\$190,000 - \$220,000
Single/HOH/MFS	\$95,000 - \$110,000

NOTE: Regardless of the phase-out limits, the beneficiary of the CESA (Education IRA) could have other contributions to the account that total \$2,000 per year (e.g. from grandparents).

TAX PLANNING: If a taxpayer cannot make a contribution to a CESA (Education IRA) because his modified AGI exceeds the phase-out range, the taxpayer could gift cash to another taxpayer whose modified AGI is less than the phase-out limits to make the maximum \$2,000 contribution for the beneficiary.

- (C) **Eligible Educational Institution:** Prior to 2002, an eligible educational institution is defined as one offering credit towards a bachelor's degree, an associate's degree, or another recognized post-secondary credential. Some vocational institutions and proprietary institutions are also eligible educational institutions. The institution must be eligible to participate in the Department of Education student aid program.

TAX LAW CHANGE - 2002 (EXPANDED DEFINITION) - GRADES K-12: For tax years beginning after 2001, the above definition has been expanded to include qualified elementary and secondary schools (e.g. grades K-12).

- (D) **Qualified Education Expenses - (Higher Education):** Qualified education expenses include tuition, fees, books, supplies and equipment, paid for post-secondary education (including undergraduate and graduate level) at an eligible education institution. IRC §529(e)(3).

Under this definition, if the student takes at least one-half of the normal full-time course load (6 credit hrs); and is enrolled in a degree, certificate, or other program leading to a recognized educational certificate, such "qualified" expenses will **also include basic room and board charges** at the school.

NOTE: There is no dollar limitation for room and board (other than actual costs).

Qualified Education Expenses (K-12): For purposes of the expansion in the definition of qualified education expenses, qualified elementary and secondary school expenses include the following:

- (1) Tuition, fees, academic tutoring, special needs services, books, supplies, computer equipment and software and other equipment in connection with the beneficiary's attendance at a public, private or religious school providing elementary or secondary education (K-12).
 - (2) Room and board, uniforms, transportation, and supplementary items or services (such as extended day programs) as required or provided by such a school.
- (E) **Distribution Rules:** Contributions to CESA (Education IRA)s are generally treated as gifts, so distributions from these IRAs can be made only to beneficiaries, not to the contributor.

CLARIFICATION - HIGHER EDUCATION EXPENSES: Distributions used to pay qualified higher education expenses are generally tax exempt even if the beneficiary attends the eligible educational institution **on a less than half-time basis**. However, if room and board expenses are to be included as qualified higher education expenses, the student **must** meet the one-half of a normal full-time workload requirement (6 credit hrs.).

- (1) IRC §72 rules will apply to CESA (Education IRA's) so that distributions are treated as representing a pro-rata share of principal and accumulated earnings. Distributions deemed to have been paid from contributions are always tax-free. Distributions of earnings are excludable from the beneficiary's gross income if the beneficiary's qualified education expenses (from the same tax year) equal or exceed the total CESA (Education IRA) distributions for that year.

EXAMPLE: Jacob receives a \$800 distribution from his CESA (Education IRA) when the account balance was \$10,000. Total contributions to his CESA (Education IRA) totaled \$7,500. The distribution is considered to come from contributions in the amount of \$600 ($\$800 \times \$7,500/\$10,000$) and from earnings in the amount of \$200 ($\$800 \times \$2,500/\$10,000$).

- (2) If distributions exceed qualified education expenses for the tax year, distributions are deemed to be paid from both contributions and from earnings on a pro-rata basis. Thus, only a portion of the "excess distribution" (the part attributable to earnings) is taxable (since contributions are non-deductible). The taxable amount is reported on Form 8606.

EXAMPLE: Using the facts of the previous example, assume Jacob's distribution consists of \$600 of contributions and \$200 of earnings. Also assume that Jacob pays \$350 in qualified education expenses for the year. Jacob can exclude \$87.50 ($\$200 \times \$350/\800), with the remaining \$112.50 of the earnings portion of the distribution, included in his income and subject to the 10% early withdrawal penalty discussed below.

- (3) The 10% early withdrawal penalty is generally imposed on any **taxable (non-qualifying) distribution** from a CESA (Education IRA). Exceptions to this rule are as follows:
- (a) Distributions made to a beneficiary or the estate of a designated beneficiary after the beneficiary's death;
 - (b) Distributions attributable to the designated beneficiary being disabled (unable to perform substantial gainful activity for indefinite duration);
 - (c) Distributions which were made in the same tax year in which the beneficiary received a scholarship or allowance, to the extent the amount of the distribution does not exceed the amount of the scholarship or allowance; **or**
 - (d) A distribution of a current year contribution and earnings thereon, or the return of an excess contribution and earnings, if the distribution is made on or before the due date of the current year's return (including extensions) by the beneficiary (e.g. October 15th at the latest, if extensions are filed).

NOTE: As stated above, for tax years beginning after 2001, taxpayers will have until the 1st day of the sixth month of the tax year following the year of contribution to make a corrective withdrawal of excess contributions, plus earnings (e.g. June 1st for calendar year taxpayers). **This date actually provides a shorter corrective time frame for those taxpayers who otherwise extend their filing due date (June 1st vs. October 15th under old law if extensions filed).**

TAX PLANNING: Beneficiaries of CESA (Education IRA)s should receive a yearly Form 5498 (IRA Contribution Information) which indicates the amount contributed during the year on their behalf. If the total of the amounts shown on all of the beneficiary's Forms 5498 exceeds \$2,000 (\$500 for tax years 2001 and prior), an excess contribution has occurred and corrective action needs to be taken.

- (F) **Interaction With Other Education Incentive Provisions -- Limitations on Distributions:** As stated above, earnings on contributions are generally distributed tax-free provided they are used to pay for qualified higher education expenses of the beneficiary. However additional rules apply, as follows:
- (1) **Hope Credit/Lifetime Learning Credit - 2002 TAX LAW CHANGE.** For tax years beginning after 2001, taxpayers will be allowed to take tax-free withdrawals from a CESA (Education IRA) in the same year a Hope or Lifetime Learning credit is claimed for the account beneficiary's college expenses. **However, the same expenses cannot be used to claim both education incentives. Generally, this should not be a problem since CESA (Education IRA) distributions can be used to offset the cost of room and board charges while the Hope and Lifetime Learning credits are only available for tuition and related expenses.**

TAX PLANNING ELECTION: If a beneficiary chooses, he can waive the option of excluding from income part or all of a CESA (Education IRA) distribution, and instead, include the otherwise excludable amount in income. IRC §530(d)(2)(C). Thus, where CESA (Education IRA) distributions are used to cover college tuition, it will generally be advantageous to claim the Hope/LLC first, and allow a portion of the CESA (Education IRA) distribution to become taxable income in the student's return. The usual 10% or 15% income tax incurred on the income portion of the CESA (Education IRA) withdrawal in the student's return will be outweighed by the savings from the 20% to 100% credit rate of the Hope/LLC. A waiver of the exclusion for a tax year is accomplished by checking the appropriate box on Form 8606.

NOTE: The 2002 Tax Act clarified that the 10% penalty does not apply to the income from this type of "excess" withdrawal, where the taxpayer has elected to claim a Hope/LLC in lieu of claiming the tuition expenditure to shelter the CESA (Education IRA) withdrawal. IRC §530(d)(4)(B)(iv). The same rule applies to a distribution from an IRC §529 Plan, to the extent the withdrawal is not expended on higher education costs because the taxpayer has elected to claim a Hope/LLC. IRC §529(c)(6).

(2) **Qualified Tuition Programs (QTP - IRC §529 Plans) - 2002 TAX LAW CHANGE:**

(a) **Contributions:** For tax years beginning after 2001, contributions can be made to both CESA (Education IRAs) and QTPs without incurring an excess contribution penalty.

(b) **Distributions:** If distributions from CESA (Education IRAs) and IRC §529 Plans exceed the student's qualified education expenses for the year (after reduction by amounts used for Hope/LLC), the beneficiary is required to allocate the qualifying education expenses between the CESA (Education IRA) and IRC §529 Plan distributions to determine the amount includible in income from each. Each excess distribution then becomes taxable based on the underlying proportion of adjusted tax basis to income.

(G) **Rollovers of CESA (Education IRAs)/Beneficiary Changes:** Rollovers from one CESA (Education IRA) into another CESA (Education IRA) are permitted if made for a member of the beneficiary's family. **Only one rollover is allowed in a 12-month period.** Also, a change in the beneficiary of a CESA (Education IRA) is permitted if the new beneficiary is a member of the same family of the original beneficiary. There is **no limit** on the number of beneficiary charges that may occur in a 12-month period.

(1) Rollover distributions are tax-free as long as the rollover occurs within 60 days of the distribution.

(2) The definition of a member of the beneficiary's family includes anyone qualifying as a dependent, or the spouse of anyone qualifying as a dependent, including descendants of children (i.e., sons, daughters, grandchildren, brothers, sisters, nephews, nieces, certain in-laws, and the spouses of those relations).

(3) As provided by the 1998 IRS Restructuring and Reform Act, to be eligible for tax-free rollovers and changes of designated beneficiaries, the new beneficiary must be under age 30.

NOTE: There is no age limit for special needs beneficiaries for tax years beginning after 2001.

TAX PLANNING: Under these rules, a parent could set up a CESA (Education IRA) for a child who could later rollover any unused CESA (Education IRA) amounts for the benefit of a living grandchild.

- (H) **Termination of CESA (Education IRAs):** The Conference Committee Report provides that any balance remaining in a CESA (Education IRA) **must** be distributed (or rolled over to another beneficiary), once a beneficiary reaches age 30. According to the 1998 IRS Restructuring and Reform Act, any undistributed balance remaining in a CESA (Educational IRA) on the date that the main beneficiary reaches age 30 or dies, will be deemed distributed within 30 days after said date.

If the CESA (Education IRA) is distributed to the beneficiary, any earnings portion is includible in income in the year of distribution.

NOTE -- EXCEPTION FOR SPECIAL NEEDS BENEFICIARY: The age 30 deemed distribution requirements are waived for special needs beneficiaries for tax years beginning after 2001.

TAX PLANNING: The CESA (Education IRA) can be rolled over to members of the designated beneficiary's family (see discussion above). A rollover would avoid taxation on accumulated earnings and the application of any penalty provisions.

NOTE -- Termination Due to Death: If a beneficiary dies prior to attaining age 30, CESA (Education IRA) funds will be distributed to his or her estate. If a spouse acquires a beneficiary's interest in a CESA (Education IRA) because of the death of the original beneficiary, the CESA (Education IRA) will be treated as if the spouse was the primary beneficiary.

NOTE: If a person other than a spouse acquires the original beneficiary's interest, the CESA (Education IRA) is deemed to terminate at death; and the account balance must be included in the original beneficiary's income in the year of death.

- (I) **Additional Rules:** Several additional provisions apply to CESA (Education IRAs):
- (1) All contributions to a CESA (Education IRA) must be in cash.
 - (2) Transfers of a beneficiary's interest in a CESA (Education IRA) to a spouse or ex-spouse under a divorce or separation agreement are **not** taxable. After the transfer, the account is treated as belonging to the spouse/ex-spouse.
 - (3) Trustees are required to report to both the IRS and the beneficiary on contribution amounts, distribution amounts, and other matters.
 - (4) The trust cannot invest in life insurance contracts.
 - (5) Trust assets cannot be commingled except in common trusts or investment funds.
 - (6) The Trustee must be a bank or other person that demonstrates to the satisfaction of the IRS that it will administer the trust as required.
 - (7) CESA (Education IRAs) are exempt from income tax except for tax on unrelated business income.

- (J) **TAX PLANNING -- COMPARISON OF CESA (EDUCATION IRAS) WITH OTHER GIFTS TO MINORS:** Generally, a gift of a CESA (Education IRA) for

the benefit of a minor is preferable to other gifts, since CESA (Education IRA) withdrawals that are not used for qualified educational expenses will typically be taxed to the beneficiary, along with a 10% early withdrawal penalty. As a result, beneficiaries should be less likely to use gifted proceeds held in a CESA (Education IRA) for unintended (non-educational) purposes.

In addition, the CESA (Education IRA) tax benefits will generally be far superior to other investments if withdrawals from the CESA (Education IRA) are used to pay qualified educational expenses. Not only do the funds inside a CESA (Education IRA) build-up without tax liability, withdrawals from the account will also be tax-free if used for their intended purpose.

However, because of the availability of qualified tuition programs (QTP) for college expenses, CESA (Education IRAs), are probably best suited for pre-college (K-12) expenses. For example, the cost of a home computer for the account beneficiary, field trips, athletic/band uniforms, etc. should all qualify to be paid from a CESA (Education IRA) account.

Since contributions to CESA (Education IRAs) are not tax deductible, the primary advantage of a CESA (Education IRA) is the avoidance of tax on the account's earnings. Unfortunately, if only limited funds will be invested in a CESA (Education IRA), this tax avoidance may be nominal and simply not worth the trouble.

VI. Qualified Tuition Programs (§529 PLAN) - IRC §529 Plans.

(A) **General:** IRC §529 (originally enacted as part of the Small Business Job Protection Act of 1996) provides tax-exempt status to "qualified state tuition programs", meaning certain programs established and maintained by a State under which persons may acquire:

- (1) **Prepaid Tuition Accounts:** Under these accounts, individuals purchase tuition credits or certificates (e.g. prepay future tuition, etc.) on behalf of a designated beneficiary that entitles the beneficiary to a waiver or payment of qualified education expenses of the beneficiary.
- (2) **Savings Accounts:** Under these accounts, individuals make contributions to an account that was established for the purpose of meeting qualified higher education expenses (undergraduate or graduate) of the designated beneficiary of the account.

For tax years beginning after 2001, distributions from qualified tuition programs are treated similarly to distributions from CESA (Education IRA) accounts (discussed above). For example, distributions to pay qualified education expenses are tax-free to the extent of qualified education expenses. Also, the earnings portion of any non-qualified distributions are subject to taxation and a 10% early withdrawal penalty.

Non-qualified distributions from a §529 Plan are taxed to the student under the annuity taxation rules of IRC §72, with the distributions being treated as representing a pro-rata share of principal and accumulated earnings in the account. IRC §529(c)(3)(A).

NOTE - FORM 1099-Q: The earnings portion of any distribution will be reported to the beneficiary (student) on Form 1099-Q. The

principal portion of any distribution under either system will not be taxed at the federal level as no deduction was received at the time of contribution to the qualified tuition program. IRC Prop. Regs. §1.529-3.

- (B) **Maximum Contribution Allowed.** The maximum contribution allowed to a §529 Plan is determined by the individual state involved (generally up to approximately \$240,000 -- Iowa = \$239,000 for 2006 and after). **Contributions are not subject to any phase-out rules based on taxpayer income levels.** Thus, higher-earning individuals may find these programs attractive due to phase-out ineligibility for other education incentive programs.
- (C) **Interaction with other Education Tax Benefits.**
- (1) **CESA (Education IRAs) - 2002 TAX LAW CHANGE:**
- (a) **Contributions:** For tax years beginning after 2001, contributions can be made to both CESA (Education IRAs) and QTPs without incurring an excess contribution penalty.
- (b) **Distributions:** If distributions from CESA (Education IRAs) and IRC §529 Plans exceed the student's qualified education expenses for the tax year (after reduction by amounts used for Hope/LLC), the beneficiary is required to allocate the qualifying education expenses between the CESA (Education IRA and IRC §529 Plan distributions to determine the amount includible in income from each. Each excess distribution then becomes taxable based on the underlying proportion of adjusted tax basis to income.
- (2) **Hope Credit/Lifetime Learning Credit:** If an exclusion from gross income is claimed for a distribution from a §529 Plan on behalf of a beneficiary, the beneficiary/distributee will still be eligible to claim the HOPE Credit or the Lifetime Learning Credit as long as different expenses are offset by the §529 Plan exclusion and the Hope/LLC claimed.
- (3) **U.S. Series EE and I Bonds:** Taxpayers may redeem U.S. Savings Bonds and take the IRC §135 exclusion, treating the proceeds as used for higher education expenses, if the bond proceeds are contributed to a §529 Plan on behalf of the taxpayer, the taxpayer's spouse, or a dependent. For this purpose, the basis in the proceeds contributed on behalf of a beneficiary to the §529 Plan is equal to the basis the contributor has in the bonds (i.e. the original purchase price plus any previously reported accrued earnings).
- (D) **Definitional Provisions:** Provisions impacting qualified tuition programs were clarified and expanded under TRA '97 to provide increased benefits to a more broadly defined group of beneficiaries. In essence, the changes made by TRA '97, as well as, changes made by EGTRRA of 2001 were identical to those made for CESA (Education IRAs) (discussed above). For example, the §529 Plan definition of "qualified higher education expenses" and the §529 Plan definition of what constitutes an "eligible educational institution", are identical to the definitions of those terms as provided for CESA (Education IRA) purposes for both pre-2002 and post-2001 usage. **Thus, qualified higher education expenses for §529 Plan purposes include expenses for room and board (if the student attended the institution on a one-half of full-time work load basis - 6 hrs. or more), and include expenses of special needs individuals.**

- (E) **Rollovers/Beneficiary Changes:** A rollover or change of beneficiaries may **only** be made between members of the same family. However, the §529 Plan definition of what constitutes a family is fairly broad.

For purposes of account rollovers and beneficiary changes, a member of the beneficiary's family includes the spouse of the original beneficiary, anyone qualifying as his/her dependent, or the spouse of anyone qualifying as his/her dependent. Family members now include sons, daughters, step-children, brothers, sisters, nephews, nieces, certain in-laws, and the spouses of these individuals. **EGTRRA of 2001 expanded this definition further so that, beginning in 2002, first cousins of the original beneficiary will be considered family members. IRC §529(e)(2).**

NOTE: EGTRRA of 2001 clarifies that a transfer (rollover) from one §529 Plan to another §529 Plan for the benefit of the **same** beneficiary will not be considered a distribution, as long **as**, only one such transfer occurs within a 12-month period. IRC §529(c)(3)(C)(iii).

Changes in Designated Beneficiaries: IRC Prop. Regs. §1.529-2(e)(1)(iv) and §1.529-1(c) clarify that no penalty is required on §529 Plan earnings payouts when the money is rolled over within 60 days to another §529 Plan set up for a different designated beneficiary. Similarly, the designated beneficiary of the §529 Plan can be changed without triggering taxation provided the new beneficiary is a member of the family of the old beneficiary. IRC §529(c)(3)(C).

TAX PLANNING: This is important when the first child does not attend college or when his or her account turns out to be over-funded.

NOTE: When the designated beneficiary is changed, there are normally no gift tax consequences, unless the new beneficiary is in a generation lower than that of the first beneficiary (then GSTT considerations apply). In that case, the first beneficiary, not the account owner, is treated as having made a gift to the new beneficiary. (Strange rule -- because the beneficiary has no control over the account -- but true).

TAX PLANNING - DONOR RETAINED CONTROL: Under most §529 Plans contributors are treated as the account owner with the right to change the designated beneficiary, or even withdraw the account. Despite these powers, §529 Plan account balances are generally not included in the contributor's gross estate (unless the contributor dies within 5 years of making the gifting election -- discussed below). This unusual but favorable estate tax rule enables contributors to remove assets from their estates while retaining control over the final disposition of the funds. Contributors may also designate a substitute (e.g. grandchild beneficiary's parent) to make decisions for the §529 Plan account.

- (F) **Estate and Gift Tax Considerations:** Annual contributions to a §529 Plan are eligible for the gift tax exclusion and excludable for purposes of the GSTT, provided that the annual gift tax exclusion is not exceeded. IRC §529(c)(2)(A).

TAX PLANNING: If a contribution in excess of the annual gift tax exclusion is made, the contributor may elect to have the contribution treated as if made pro-rata over a five-year period (e.g. \$60,000 per contributor; \$120,000 per married couple (for 2006-2008)). In this case, a gift tax return will need to be filed. IRC §529(c)(2)(B).

EXAMPLE: John contributes \$45,000 to a §529 Plan for the college education of his daughter, Jean. This gift could be treated as made over 5 years; and, thereby a \$9,000 per year gift would be deemed to have been made by John to his daughter. Since this amount is under the current annual gift tax exclusion of \$12,000, there would be no gift tax consequences to John.

NOTE: If a contributor who made an excess contribution dies during the five-year period, the portion of the contribution that had not been allocated to the years prior to death is includible in the contributor's estate. IRC Prop. Regs. §1.529-5(d)(2). However, if the designated beneficiary dies, the §529 Plan account balance is **not** included in the contributor's gross estate. IRC Prop. Regs. §1.529-5(d)(3). The contributor will merely change the beneficiary designation to another "family" member.

NOTE -- EFFECT ON GSTT: In the event of a rollover of §529 Plan funds, there are no transfer tax consequences if the beneficiaries are of the same generation. If the beneficiaries are of different generations, a 5-year averaging rule may be applied to exempt up to \$60,000 per contributor (\$120,000 for a married couple) of the transfer from gift tax. IRC §529(c)(5) and Prop. Regs. §1.529-5(b)(3)(ii).

NOTE: The effective date of the gift tax provisions set forth above was August 5, 1997. Contributions made prior to this date were **not** treated as completed gifts.

(G) **Additional Rules/Comments:** The IRS has released proposed regulations regarding qualified tuition programs (§529 Plan). Several rules regarding these programs are clarified as follows:

- (1) **Separate Accounts:** §529 Plan's must maintain separate accounts for each designated beneficiary to keep track of contributions, earnings, and distributions. Prepaid plan account balances can be expressed in terms of educational credits or units rather than fair market value (FMV). IRC Prop. Regs. §1.529-2(f).
- (2) **Investment Direction:** Contributors and/or designated beneficiaries cannot generally direct how §529 Plan account balances are invested after contributions have been made. IRC §529(b)(5). However the person establishing the account is permitted to select among different investment strategies offered by the Plan. IRC Prop. Regs. §1.529-2(g).

In Notice 2001-55, the IRS announced rules that provide some additional flexibility regarding §529 Plan investment strategies. The person who established the §529 Plan account may now change investment strategies (only among these offered by the §529 Plan) once per calendar year and upon a change in the designated beneficiary. Notice 2001-55, IRB 2001-39 (9-24-01).

- (3) **Contribution Limits:** §529 Plan's must take measures to ensure that contributions will not exceed the amount needed to finance the designated beneficiary's qualified higher education expenses. IRC Prop. Regs. §1.529-2(i)(2).
- (4) **Penalties on Nonqualified Payouts - 2002 TAX LAW CHANGE:** For tax years beginning after 2001, a 10% early withdrawal penalty is imposed for non-qualified distributions. The application of the 10% early withdrawal penalty mirrors the penalty application for non-qualified distributions from CESA (Education IRAs).

NOTE - COLLEGE FINANCIAL AID: Some states don't consider §529 Plan participation in determining eligibility for state-sponsored financial aid programs. However, the general rule is benefits from prepaid plans are considered a "resource" and will reduce a student's financial need on a dollar-for-dollar basis.

- (H) **Private Educational Institution §529 Plans:** EGTRRA of 2001 expanded the definition of "qualified tuition programs" to include prepaid tuition programs established and maintained by private educational institutions as long as the prepaid tuition program had received a ruling or determination from the IRS that the program satisfied applicable IRC §529 requirements.

The change in tax law will permit private educational institutions to sponsor tax-free §529 Plans that offer prepaid tuition credits or certificates. Private educational institutions will not be allowed to offer college savings account plans.

The earnings on distributions for "qualified higher education expenses" from IRC §529 programs established by private educational institutions will be eligible for exclusion from income for tax years beginning in 2004 and thereafter (e.g. allowed tax-free treatment after that date). A special rule will apply to distributions prior to this date so that a 10% early withdrawal penalty will not apply to an otherwise "non-qualified" distribution of earnings. While the 10% early withdrawal penalty will not apply, the earnings portion of a pre-2004 distribution will be included in the gross income of the beneficiary. Apparently, Congress believed that conforming the penalty to the CESA (Education IRA) provisions will make it easier for taxpayers to allocate expenses between the various education tax incentives.

Trust Fund Requirement: The assets of a private institution's §529 Plan must be held in a trust created or organized in the United States for the exclusive benefit of designated beneficiaries. The trust must comply with the requisites of IRC §408(a)(2) and (5). Under these rules, the trustee must be a bank or other person who demonstrates that it will administer the trust in accordance with applicable requirements. The assets of the trust may not be commingled with other property except in a common trust fund or common investment fund.

- (I) **Research/Websites:** To review the various state §529 Plans, check out the following websites:

- www.savingforcollege.com -- A website dedicated to IRC §529 Plans. This website contains a free §529 Plan evaluator tool for comparing selected features of the various state plans.
- www.collegesavings.org -- Links to each of the state plans.

- (J) **Advantages of Qualified Tuition Programs (IRC §529 Plans) Over CESA (Education IRAs):**

- (1) **Control:** Donor may serve as owner, retain the ability to withdraw unused plan amounts (although income recognition on earnings and a 10% penalty will occur), change the beneficiary designation to another family member. Even though the donor retains these controls, the investment is considered a gift at inception; and, is therefore, removed from the donor's estate.

EXCEPTION: Limited control over investment strategy.

- (2) **Contribution Amounts/AGI Phase-out:** No nominal (\$2,000 CESA (Education IRA)) contribution limit and **no AGI phase-out**

eligibility limit applicable to the donor when contributing to a §529 Plan. Gift tax exclusions and exemptions provide the only limitations on contributions.

- (3) **Distribution:** There is **no age limitation for distribution** to a designated beneficiary. The donor can control when the account transfers to the next generation (CESA (Education IRAs) = age 30).
- (4) **Age Limitations:** §529 Plan can be established at any age. (CESA (Education IRAs) can no longer be funded after the beneficiary attains age 18).
- (5) **State tax savings:** Contributions to a QSTP may be eligible for a state income tax deduction.
- (6) **Less FAFSA Impact:** Since ownership of the §529 Plan is retained by the donor, only 5.6% of the value will be included in the expected family contribution for FAFSA purposes. If the designated beneficiary were treated as the owner, 35% would be included.

NOTE: If donor = grandparents, nothing is included for FAFSA purposes.

- (7) **Bankruptcy Protection:**
 - (a) **Beneficiary:** Since beneficiary does not have the right to receive distributions and does not have control over the account, account would not be included as an asset of the designated beneficiary.
 - (b) **Donor:** Since donor retains controls over investment decisions/distribution of assets, creditors should be able to get to Plan assets absent a state statute granting special creditor protection for §529 Plan accounts. (**NOTE:** New York and Alaska have adopted)..

POSSIBLE SOLUTION: Consider changing party responsible for Plan prior to the time that transfer would be treated as a preference in bankruptcy.

VII. **Education (Student) Loan Interest -- IRC §221.**

- (A) **Maximum Yearly Deduction:** Under IRC §221, individuals are allowed to deduct interest paid on any qualified education loan, subject to the following limits:

Year	Max. Deductible Interest
1998	\$1,000
1999	\$1,500
2000	\$2,000
2001 and after	\$2,500

NOTE: The deduction for interest on qualified educational loans will be taken as a deduction for AGI (above-the-line).

NOTE: An individual is not entitled to the deduction if the taxpayer may be claimed as a dependent by another taxpayer for the tax year beginning in the calendar year in which the individual's tax year begins. For married taxpayers, the deduction is allowed only if the taxpayer and the spouse file a joint return for the year. There is no deduction for individuals who file on a married filing separately basis. IRC §221(f)(2).

NOTE: Student loan interest is only deductible by a taxpayer who is legally obligated to make interest payments pursuant to the terms of the loan. In the case of payments made by a third party who is not legally obligated to make the payment, the taxpayer is treated as receiving the payment from the third party and, in turn, making the payment. IRC Regs. §1.221-1(b)(4)(i).

- (B) **Qualified Education Loan.** The 1998 IRS Restructuring and Reform Act defined "qualified education loan" as indebtedness incurred by a taxpayer solely to pay qualified education expenses of the taxpayer, spouse, or a dependent of the taxpayer at the time the debt was incurred. Therefore, the **interest on a revolving line of credit will not qualify if a taxpayer does not agree to use the line of credit solely for education expenses.**

Qualified education expenses must be paid within a "reasonable" time before or after the education loan indebtedness was incurred (generally 90 days before or after the academic term begins or ends). Also the individual must have been enrolled in a degree or certificate program with at least half of a full-time work load at an eligible education institution.

NOTE: A qualified education loan also includes debt to refinance a qualified education loan as long as the proceeds are used solely for that purpose.

NOTE: Any debt owed to a related party as defined in IRC §267(b) and §707(b)(1) is not a qualified education loan.

<p>EXAMPLE: The interest paid to grandparents for an education loan is not deductible because the grandparents' loan does not meet the definition of a qualified education loan.</p>

- (C) **Qualified Higher Education Expenses.** Includes the cost of **tuition, fees, room and board, and related expenses, such as books, supplies and transportation** to attend an eligible education institution. Qualified expenses are reduced by the following:
- (1) Distributions from CESA (Education IRAs) or §529 Plans which are excluded from gross income;
 - (2) Qualified scholarships excludable from gross income under IRC §117;
 - (3) Exclusions for interest earned on U.S. Series EE and I bonds under IRC §135; and
 - (4) Amounts deducted as business expenses (e.g. employer-provided education assistance).
- (D) **Eligible Education Institution.** Includes post-secondary educational institutions and vocational schools, as well as, hospitals and health care facilities offering post-graduate training.

- (E) **Phase-out of Deduction.** The amount of interest that may be deducted will be phased-out on a prorata basis as follows:

FILING STATUS	MODIFIED AGI PHASE-OUT RANGE (2007)	MODIFIED AGI PHASE-OUT RANGE (2008)	MODIFIED AGI PHASE-OUT RANGE (2009)
MFJ	\$110,000 - \$140,000	\$115,000 - \$145,000	\$120,000 - \$150,000
Single/HOH	\$55,000 - \$ 70,000	\$ 55,000 - \$ 70,000	\$ 60,000 - \$ 75,000
MFS	Not allowed	Not allowed	Not allowed

The term "modified AGI" (as defined in the statute) generally includes AGI **determined without regard** to the foreign earned income exclusion, the domestic production activities deduction, and the tuition and fees deduction. IRC §221(b)(2)(C).

NOTE: The AGI phase-out amounts will be indexed for inflation in multiples of \$5,000 after the year 2002.

- (F) **LOAN ORIGINATION FEES/CAPITALIZED INTEREST.** Loan origination fees and interest that is accrued and added to the principal of a loan (capitalized) are treated as interest when paid. IRC Regs. §1.221-1(h)(2). For purposes of this rule, payments on student loans are allocated as follows:

- (1) First, to newly accrued interest that is due on the date of the payment;
- (2) Second, to loan origination fees/capitalized interest until such amounts are reduced to zero; and
- (3) Third, to principal.

Thus, a portion of the initial principal paid on a student loan, for which loan origination fees and/or accrued but unpaid interest were added to principal, would be deductible as student loan interest. Pursuant to the above ordering rules, 100% of the initial principal payments on the student loan would be deductible (subject to yearly deduction limits) until the full amount of the loan origination fees and/or capitalized interest has been accounted for.

- (G) **Form 1098-E:** Businesses receiving \$600 or more of interest from an individual on one or more qualified education loans will need to file Form 1098-E, Student Loan Interest Statement, under normal reporting requirements.

NOTE: The IRS has waived payee penalties under IRC §6721 and §6722 for failure to report on Form 1098-E, calendar year qualified education loan payments attributable to loan origination fees and capitalized interest. Penalties were waived beginning with 2004 filings if the payee:

- (1) Filed and furnished in a timely manner a Form 1098-E (or other appropriate information statement) that included the amount of interest (except for any loan origination fees or capitalized interest) received; **and**
- (2) Furnished a statement to the borrower indicating that the amount of interest reported on Form 1098-E did not include payments attributable to either loan origination fees or capitalized interest received on qualified education loans and that the borrower may be able to deduct amounts in addition to the amount reported.

Borrowers can use any reasonable method to allocate loan origination fees over the term of the loan for purposes of computing deductible interest. Notice 2004-63, 2004-41 IRB (Oct. 12, 2004).

NOTE: The payee who is required under IRC §6050S to report interest on education loans on Form 1098-E, is not required to verify the payor's actual use of funds. The payee may rely on the payor's certification that the loan proceeds will be used solely for qualified higher education expenses when the loan is initiated.

VIII. **Cancellation of Certain Student Loans -- IRC §108(f):** As clarified by the 1998 IRS Restructuring and Reform Act, if a tax-exempt organization refinances an existing student loan on behalf of a student, the student must be required to fulfill a public service work requirement to be eligible to exclude the debt forgiveness from income. IRC §108(f)(2).

FIGURE 6.13 COSTS ELIGIBLE FOR EDUCATION BENEFITS

	Hope	Lifetime Learning	Coverdell ESA	§529 Plans	Higher Education Deduction	U.S. Savings Bonds	Student Loan Interest
Tuition & fees required for enrollment	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Books, supplies & equipment—only if fees must be paid to an eligible educational institution for enrollment of student	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Room & board—must be at least half-time student at eligible institution	No	No	Yes	Yes	No	No	Yes
Additional expenses for special-needs student	No	No	Yes	Yes	No	No	No
Postsecondary	Yes	Yes	Yes	Yes	Yes	Yes	Yes, with special rules
Elementary/secondary	No	No	Yes	No	No	No	No
Non-degree courses	No	Yes	No	No	No	No	No

FIGURE 6.14 COORDINATION OF EDUCATION COSTS/CREDITS
Can both provisions be used in the same year?

	Hope	Lifetime Learning	Coverdell ESA	§529 Plans	Higher Education Deduction
Hope	x	No (for same individual) Yes (for another qualifying individual)	Yes	Yes	No
Lifetime Learning	No (for same individual) Yes (for another qualifying individual)	x	Yes	Yes	No
Coverdell ESA	Yes	Yes	x	Yes (for contributions and distributions)	Yes
§529 Plans	Yes	Yes	Yes (for contributions and distributions)	x	Yes
Higher Education Deduction	No	No	Yes	Yes	x

Comparison of Education Expenditure Tax Incentives (2008)

Attribute	Hope Scholarship Credit	Lifetime Learning Credit	Series EE Bond Interest Exclusion	Deduction for Education Loan Interest	Qualified Tuition Deduction	Qualified Tuition Program (QTP)	Education Savings Account (ESA)
IRC Sec.	25A	25A	135	221	222	529	530
Modified AGI phase-out range: Married joint Single and HOH Married separate	96,000/116,000 48,000/ 58,000 0	96,000/116,000 48,000/ 58,000 0	100,650/130,650 67,100/ 82,100 0	115,000/145,000 55,000/ 70,000 0	\$130,000/160,000 ^a 65,000/ 80,000 ^a 0	N/A N/A N/A	\$190,000/220,000 95,000/110,000 95,000/ 110,000
Tax benefit	Tax credit	Tax credit	Interest income not taxed	Above-the-line interest deduction	Above-the-line tuition deduction	Tax-free college savings	Tax-free education savings
Annual limit	\$1,800/student (100% first \$1,200; 50% next \$1,200)	\$2,000 per return (20% of up to \$10,000 of qualified expenses)	Amount of qualifying expenses	\$2,500	\$4,000/2,000	Total contributions per beneficiary determined by QTP	Total contributions for a beneficiary cannot exceed \$2,000
Qualified education expenses	Tuition & fees Books ^b	Tuition & fees Books ^b	Tuition & fees QTP contribution ESA contribution	Tuition & fees Books Room & board Transportation	Tuition & fees Books ^b	Tuition & fees Books Room & board ^c QTP contribution Family computer ^d	Tuition & fees Books Room & board ^c QTP contribution Family computer ^d
Qualifying education	First two years of undergraduate	Undergraduate and graduate	Undergraduate and graduate	Undergraduate and graduate	Undergraduate and graduate	Undergraduate and graduate	Undergraduate and graduate; also grades K-12
Degree program required	Yes	No	No	Yes	No	No	No
More than half time attendance required	Yes	No	No	Yes	No	No	No
Other selected conditions and rules	Cannot claim if Lifetime Learning Credit is claimed for same student Third party payments attributed to student; payments by dependents attributed to parents Student can claim credit as parents forgo claiming the dependency exemption	Cannot claim if Hope Scholarship Credit is claimed for same student Third-party payments attributed to student; payments by dependents attributed to parents Student can claim credit even if dependent as long as parents forgo claiming the dependency exemption	Applies only to bonds issued after 1989 or Series I bonds Bonds cannot be owned by student	Student cannot claim deduction if a dependent Loan must be incurred solely to pay qualified education expenses	Deduction not allowed in year education credit claimed with respect to same student Student cannot claim deduction if a dependent Cannot claim deduction for expenses paid with excludable income Restriction on tuition prepayments	10% penalty on nonqualified distributions Account owner retains control over beneficiary designation and can reclaim funds Contributions treated as gift of a present interest; election available to spread gift over five years	Mandatory distributions at age 30 10% penalty on taxable portion of nonqualified distributions Okay to contribute to both ESA and QTP for same beneficiary Contribution deadline: April 15th

Notes:

- ^a No phase-out range. Full deduction (\$4,000) allowed if modified AGI does not exceed lower threshold amount. Reduced deduction (\$2,000) allowed if modified AGI does not exceed upper threshold amount. No deduction if modified AGI exceeds upper threshold amount.
- ^b Books qualify as education expenses only if they must be paid to the eligible educational institution as a condition of enrollment or attendance at the institution
- ^c Room and board qualify as education expenses only if the student carries at least half the normal full-time workload for the student's course of study.
- ^d Used by account beneficiary (student) and the beneficiary's family during any of the years the beneficiary is in school.

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COLLEGE FINANCIAL AID

- (1) **General:** Colleges determine a student's need for financial aid under the following formula:

Cost of Attendance (COA)	\$	
LESS: <u>Expected Family Contribution (EFC)</u>		(_____)
Financial Need	\$	<u>_____</u>

- (2) **Cost of Attendance (COA):**

- (a) The COA is unique to each institution, and reflects its total annual costs for tuition, fees, room and board, books, supplies, transportation, and personal expenses.
- (b) All of these items are eligible for financial aid, but not all education institutions will factor transportation and personal expenses into their COA amount.
- (c) **NOTE:** When comparing financial aid offers from competing colleges, the content of the COA should be scrutinized. Each institution may not be starting with a comparable COA figure because of inclusion or omission of transportation and personal expenses.

- (3) **Expected Family Contribution (EFC):**

- (a) **The EFC is unique to each student, and represents the amount the student and family are expected to contribute towards annual post-secondary education costs.**
- (b) The amount is calculated under a federal formula, based on data submitted to the U.S. Department of Education on the Free Application for Federal Student Aid (FAFSA) forms.
- (c) **The EFC is divided by the number of family members enrolled in higher education (i.e. enrolled for at least 6 credit hours in one term and working toward a degree or certificate at an accredited post-secondary institution).**
- (d) For a student's financial aid to be determined independent of his or her parents, the student must meet one of the following criteria:
 - (1) Attained age 24 by December 31st of the school year;
 - (2) Veteran of U.S. armed forces active duty;
 - (3) Married;
 - (4) Graduate/professional program student (post-bachelor degree); or
 - (5) Both parents deceased, or student is a ward of the Court.

**EXPECTED FAMILY CONTRIBUTION
(Federal Methodology Formula)**

<u>PARENT/CHILD</u>	<u>EXEMPTION ITEMS</u>	<u>RATE</u>	<u>CONTRIB.</u>
Parent's AGI plus Untaxed Income & Benefits	- Income Protection (Living) Allowance Fed. Income Taxes Soc. Sec. Taxes State Tax Allowance (IA = 4%) Employment Expense Allowance	22- x 47% =	Parents' Contribution from Income
Parents' Assets	- Asset Protection Allowance	2.6- x 5.6% =	Parents' Contribution from Assets
Student's AGI plus Untaxed Income & Benefits	- Federal Income Taxes State Taxes Social Security Tax Income Protection Allowance (\$3,000)	x 50% =	Student's Contribution from Income
Student's Assets	- Nothing	x 35% =	Student's Contribution from Assets
			= Expected Family Contribution (EFC)

NOTES: All EFC allowances (dollar amounts and ranges) were taken from updated tables prepared by the Department of Education for the 2008-09 college award year. The tables can be accessed online at:

<http://www.ifap.ed.gov/IFAPWebApp/currentEFCInformationPag.jsp>

Income Protection (Living) Allowance: Generally, ranges from \$12,750 - \$32,650, depending upon number of total household members and number of students in college (i.e. 4 household members with 1 student = \$23,660).

The current year income protection allowances for parents of dependent students and independent students with dependents other than a spouse are:

Family Size	Number in College				
	1	2	3	4	5
2	\$15,380	\$12,750			
3	\$19,150	\$16,540	\$13,900		
4	\$23,660	\$21,020	\$18,410	\$15,770	
5	\$27,910	\$25,280	\$22,660	\$20,030	\$17,410
6	\$32,650	\$30,010	\$27,400	\$24,770	\$22,150

For each additional family member add \$3,680.
For each additional college student subtract \$2,620.

Employment Expense Allowance: The employment expense allowance for parents of dependent students, married independent students without dependents other than a spouse, and independent students with dependents other than a spouse is the lesser of \$3,300 or 35% of earned income of the individual or lower earning spouse.

Factor for Parent's Contribution From Income: 47% rate applies if AGI minus exclusions is above \$27,801. Rate begins at 22% and increases to 47% for amounts between \$3,410 and \$27,801.

Permitted Exclusions from Parent's Assets: Qualified retirement plan accounts, annuities, CSV of life insurance, household items, personal autos, the principal residence and a family-operated farm. Also, a formula lowers the value of a business or an investment farm by up to 40% - 60% if assets values do not exceed \$550,000.

If the net worth of the business/farm is:	Then the adjusted net worth is:
Less than \$1	\$0
\$1 to \$110,000	\$ 0 + 40% of net worth (NW)
\$110,001 to \$330,000	\$ 44,000 + 50% of NW over \$110,000
\$330,001 to \$550,000	\$154,000 + 60% of NW over \$330,000
\$550,001 or more	\$286,000 + 100% of NW over \$550,000

Asset Protection Allowance: Based on age of older parent as of each December 31st. Examples: Age 45 = \$43,400 (approx.); age 55 is \$56,300 (approx.). The allowance is smaller for a single parent.

PARENT(S) - FOR FAFSA PURPOSES: The FAFSA instructions include the following as part of Section 5 on Parent Finances:

" -If your parent is **widowed or single**, answer the questions about that parent. If your widowed parent is **remarried** as of today, answer the questions about that parent and the person to whom your parent is married (your stepparent).

"-If your parents are **divorced or separated**, answer the questions about the parent you lived with more during the past 12 months. If you did not live with one parent more than the other, give answers about the parent who provided more financial support during the past 12 months, or during the most recent year that you actually received support from a parent. If this parent is **remarried** as of today, answer the questions about that parent and the person to whom your parent is married (your stepparent)."

NOTE: For FAFSA purposes, a separation need not be a legal separation. The student's parents may consider themselves separated when one of the parents has left the household for an indefinite period of time and no longer makes a substantial contribution to the finances of the household. If the student did not live with one parent more than with the other (e.g. joint custody or in the case of a married couple who divorced or separated immediately before the financial aid application was signed), the income and asset information of the parent who provided the majority of financial support during the last twelve months, or during the most recent calendar year that the student was actually supported by a parent, is listed. This may **not** be the parent who claimed the student on his tax return **or** the one who was awarded custody by a court order.

NOTE: Support includes money, gifts, loans, housing, food, clothes, car, medical and dental care, payment of college costs, etc."

(4) **Financial Need:**

- (a) Each educational institution determines a student's financial need by starting with the institution's cost of attendance (COA), and subtracting the student's expected family contribution (EFC).
- (b) The institution will attempt to meet the financial need, if any, with a combination of financial aid elements.
 - (1) **Gift vs Self-help Aid:** Financial aid may be gift aid (scholarships and grants), and self-help aid (work-study arrangements and/or student loans).
 - (2) **NOTE:** In comparing financial aid offers from competing educational institutions, a careful comparison should be made of the breakdown between gift aid and self-help amounts. More expensive private institutions are likely to

offer more gift aid, reducing the true cost of attendance, whereas public institutions may offer more loans and work-study arrangements. The family should compare the net cost after considering only gift aid to determine the true out-of-pocket cost of attendance.

- (c) **A Financial need calculator is available at the following site:**
www.finaid.org/calculators/scripts/estimate.cgi.

RESOURCE GUIDE: For a further resource on the college financial aid system, see Practitioners Publishing Company's Guide to College Financial Aid, a part of the Beibl-Ranweiler Portfolio Series (Portfolio No. 13). This particular portfolio, containing eight chapters covering the college financial aid system, can be acquired with supplemental software that allows advance calculation of the family's EFC under the federal financial aid formula. For more information concerning this portfolio, call 1-800-323-8724. The Guide to College Financial Aid is authored by Rick Darvis, CPA and Ronald Them, CEP.