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Educational Tax Benefits

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The Internal Revenue Code contains a number of deductions and credits to subsidize the cost of higher education, which are multiple, overlapping and somewhat conflicting. Some of these are permanent provisions and some of them are temporary. Besides one, all of the benefits contain adjusted gross income (AGI) limitations and phase-outs, which add to the complexity.

American Opportunity Tax Credit (AOTC)

The American Recovery and Investment Act of 2009 modified the Helping Outstanding Pupils Educationally (HOPE) scholarship credit, renaming it the American Opportunity Tax Credit for 2009 and 2010. The Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 (the 2010 Tax Relief Act) extended the AOTC for 2011 and 2012. The AOTC is a tax credit for some qualified tuition and related expenses that the taxpayer pays for himself, his spouse or a dependent. AOTC covers up to 100 percent of a student's first $2,000 of tuition and related expenses, plus 25 percent of such expenses in excess of that amount up to a maximum credit of $2,500. The credit is available per student for post-secondary education of a student who carries at least half the normal full time load for at least one academic period and only for the student's first four years of post-secondary education, but not beyond college.

The AOTC was refundable up to 40 percent of the $2,500 for 2009 and 2010, and was extended for 2011 and 2012 by the 2010 Tax Relief Act. The credit is phased out for:

- Single taxpayers whose AGI is between $80,000 and $90,000 and
- Married taxpayers filing a joint return whose AGI is between $160,000 and $180,000.

Lifetime Learning Credit

The lifetime learning credit is available on a per taxpayer basis for postsecondary education including graduate school. The lifetime learning credit and the AOTC cannot be claimed for the same student for 2010 through 2012, however a taxpayer can claim one credit for one child and the other credit for another child. There is no limit on the number of years for which a taxpayer can claim the lifetime learning credit for the same student's expenses and there is no requirement that the student be enrolled at least part time for at least one academic period as there is with AOTC. The tuition and related expenses subject to the credit includes only the amount of tuition and related expenses that the student pays and does not include those items for which a tax-free scholarship, fellowship or any other tax-free educational assistance programs pay.

The maximum lifetime learning credit is 20 percent of the first $10,000 of qualified tuition and related expenses. The full lifetime learning credit is available to:

- Single taxpayers with less than $50,000 of AGI and

- Married taxpayers filing joint returns with less than $100,000 AGI.

The credit is phased out for single taxpayers with AGI between $50,000 and $60,000 and married taxpayers filing joint returns with AGI between $100,000 and $120,000.

Coverdell Education Savings Accounts (ESA)

Changes made to Coverdell ESAs in 2001 (including a higher maximum contribution amount) were scheduled to expire, but the 2010 Tax Relief Act has extended these enhancements through 2012. A Coverdell ESA is an account created to pay a designated beneficiary's qualified education expenses to which a maximum of $2,000 can be contributed annually for any one beneficiary. For these purposes, qualified education expenses are higher-education expenses, such as tuition, books, supplies, as well as room and board and qualified elementary and secondary school expenses. Expenses do not include any expenses taken into account for the AOTC or the lifetime learning credit. Distributions from a Coverdell ESA are tax free as long as they do not exceed the beneficiary's qualified education expenses. An account can only be for a beneficiary under the age of 30 and may be rolled over tax-free to another member of the beneficiary's family who is under 30.

Single taxpayers with AGI of $95,000 or less and married taxpayers filing a joint return with AGI of $190,000 or less can contribute the maximum annual amount of $2,000. The maximum amount is phased out for single taxpayers with AGI between $95,000 and $110,000 and married taxpayers filing joint returns with AGI between $190,000 and $220,000.

Qualified Education Expense Above the Line Deduction

The deduction for qualified education expenses expired at the end of 2009, but the 2010 Tax Act has retroactively extended the deduction through 2011. For tax years beginning before January 1, 2012, a taxpayer may deduct above the line $4,000 of qualified education expenses if the taxpayer's AGI does not exceed $65,000 ($130,000 for married taxpayers filing jointly) and $2,000 if the taxpayer's AGI exceeds $65,000 but does not exceed $80,000 (between $130,000 and $160,000 for married taxpayers filing jointly). A married taxpayer filing separately is not eligible for the deduction. In addition, a taxpayer who claims an AOTC or lifetime learning credit for a student for whom the expenses were paid is not eligible for the deduction.

Tuition payments paid by a taxpayer on behalf of someone else are excluded from the gift tax, if the tuition payments are made directly to the educational organization.

529 Plans

A 529 plan is a qualified tuition program that is maintained by a state, state agency or educational institution that complies with restrictions on contributions, investments and beneficial distributions.

Distributions from a 529 plan eligible for higher-education expenses, such as tuition, room and board, fees, books and computers, are tax exempt and will not be taxable to the beneficiary or the person who made the contributions to the plan. Distributions in excess of the beneficiary's qualified higher-education expenses are subject to a 10 percent penalty. In addition, contributions qualify for the gift-tax annual exclusion and any contribution in excess of the annual exclusion amount may be treated for gift-tax purposes as having been made over a prospective five-year period. A married couple can contribute $130,000 to a 529 plan and treat the contribution as being made over a five-year period in $13,000 installments by each person, thereby qualifying for the annual exclusion in each year.

Expenses taken into consideration for the AOTC or lifetime learning credit will not be considered qualified higher-education expenses under a 529 plan.

There are no AGI limitations on high-income taxpayers funding a 529 plan. A donor to a 529 plan may contribute to a plan in any state, even a state in which the donor is not domiciled and does not need to be related to the beneficiary to fund a 529 plan. In addition, some states permit an income-tax deduction for contributions by a state resident to a state of residence 529 plan. For example, in Illinois, single taxpayers can deduct $10,000 and joint filers can deduct $20,000 for contributions to an Illinois 529 plan. New York provides a $5,000 deduction for single taxpayers and $10,000 for joint filers for contributions to a New York 529 plan.

If the beneficiary does not go to college or fails to use all of the funds in the 529 plan, the account owner can change the designated beneficiary without any income or gift-tax consequences as long as the new beneficiary is a member of the original beneficiary's family, which is broadly defined.

Miscellaneous Education Tax Provisions

There are a number of other educational tax benefits. The 2010 Tax Act extended through 2012 the exclusion from gross income for income-tax purposes and from wages for employment-tax purposes of up to $5,250 annually of educational assistance provided by an employer if certain requirements are met. Also extended through 2012 is the above-the-line deduction for interest paid on qualified education loans, subject to a maximum annual deduction limit. In addition, interest earned on qualified U.S. savings bonds can be excluded from income when the bonds are cashed in to pay qualified higher-education expenses.

Conclusion

Higher education is tax subsidized by a number of confusing, complicated and conflicting provisions. Even after the extension of some of these educational tax benefits by the 2010 Tax Relief Act and the President's proposal to make the AOTC permanent, what is needed is a complete overhaul and simplification of the provisions to provide the tax benefits to those who need them.

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