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College Prep: What Every Consumer Should Know about Education Expenses and the Economic Growth & (and) Tax Relief Act of 2001

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STUDENT ARTICLES

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Regina Rathnau

A. Introduction

Since 1959, states have been offering alternatives to help their citizens save for their family's education.[1] Governments have begun to recognize the value of an education as well as the daunting expense of one. Education expenses have increased more than health care costs and inflation, given that the cost of college tuition has increased over 280 percent since 1980.[2] Despite the increase in the cost of post-secondary schooling, statistics show that higher education is now vital: people with a college degree earn 81 percent more on average than those with only a high school diploma.[3] Over a lifetime, the gap in earning potential between a high school diploma and a college degree could potentially be more than $1,000,000.[4]

The federal government has tried to help taxpayers with education expenses over the past decade through the use of tax credits, Education Individual Retirement Arrangements ("Education IRAs"), tax-deferred savings, prepaid tuition plans, and various other government programs. While these tax breaks provide appreciable relief to the college-bound American, some did not provide enough relief for the middle class and provided even less relief for the low-income taxpayer. The Economic Growth and Tax Relief Reconciliation Act of 2001 ("Tax Act"), signed into law on June 7, 2001 by President Bush, is the new administration's attempt to provide genuine relief to taxpayers in hopes to see their children get a post-secondary education. Despite being signed in 2001, however, its benefits are not available until 2002, which is important to remember when making financial decisions.

There is no doubt that the new Tax Act provides attractive features for parents helping their children with tuition, as well as those current students paying their own tuition. Potential pitfalls and problems exist, however, and a savvy consumer should be aware of them when taking advantage of the various tax breaks. Ignorance of the ramifications of such provisions would provide not only frustration but also financial loss. The programs that minimize education expenses are intended to help the middle and lower income taxpayers. Thus, it is frustrating that the average person needs a personal finance expert to analyze the rules and coordinate the most advantageous strategy that is free from hidden penalties or denied benefits.

The first goal of this article is to identify the basic parameters of the five major education tax breaks that benefited from the recent Tax Act and are touted by government and financial institutions. The article then describes the problems that the uninformed taxpayer could encounter upon trying to save on education expenses. Congress only recently enacted the Tax Act, so there is little data to demonstrate the success of these programs. However, the potential benefits are tangible – if the consumer only knew how to utilize the Tax Act to avoid problems and receive profits.

B. Types of Education Expense Tax Breaks

1. § 529 Plans ("QSTPs")

In 1996, Qualified State Tuition Programs ("QSTPs") were created and governed by Internal Revenue Code § 529. These plans permitted states to offer two distinct types of state-governed programs that allowed taxpayers to contribute after-tax dollars so that they could grow tax-free while invested in the programs.[5] The Joint Committee on Taxation provides a thorough definition of a QSTP in the following:

> A Qualified State Tuition Program is a program established and maintained by a state or agency under which persons may (1) purchase tuition credits or certificates on behalf of a designated beneficiary that entitle the beneficiary to a waiver or payment of qualified higher education expenses of the beneficiary, or (2) make contributions to an account that is established for the purpose of meeting qualified higher education expenses of the designated beneficiary.[6]

While all states have finally adopted one or both forms of QSTPs, some states, like Louisiana, have special residency requirements for their prepaid tuition or savings plans.[7] Consequently, it is important to determine whether an individual qualifies for a particular state's plan, as well as whether that plan fulfills the investor's goals based on the individual state plan. Another important point to consider is that these plans are much more useful to investors with young children, who will significantly benefit from locked-in tuition rates and long periods of tax-deferred growth, assuming that tuition rates continue to rise and the market has overall improvement over the period the savings account is held. These plans have numerous benefits, yet there are also some noteworthy drawbacks and conditions of which every participant should be aware.

As previously stated, a prepaid tuition plan allows an individual, often a parent, to buy tuition credits at today's rate, and that individual may use the credits years from now. Like a defined benefit pension plan, the plan protects investors from potential losses by guaranteeing to cover college tuition even if prices rise faster than expectations and the final cost exceeds the ultimate value of the investment.[8] Some states, like Kentucky, however, permit the tuition credits to be used for in-state educational institutions.[9] Other states, like Colorado, will pay the full value of the credits at the full value of the amount originally invested.[10] There are also states like Illinois that permit credits to be used at private or out-of-state institutions, but usually for less than the full amount of tuition.[11]

A donor need not worry that the money is lost forever if the child receives a scholarship or decides not to go to college. Receipt of a scholarship or death of the beneficiary generally allows the donor to either get a refund of the money invested or to roll the money over to apply to a different beneficiary.[12] The definition of "qualifying beneficiary" for a rollover under § 152(a)(1)-(9) encompasses just about any imaginable family member.[13] If the beneficiary chooses not to attend college and no one else can use the credits, a refund of contributions, minus a federally-imposed penalty, is generally available to the donor.[14]

Despite the benefits of the QSTP prepaid tuition plan, the QSTP savings plan is more popular due to greater flexibility and more tax savings. Normally, a donor completes an agreement with the financial institution, such as TIAA-CREF or Fidelity Investments, which is operating the plan for the state. The donor selects one of several mutual funds offered by the institution based upon different criteria (i.e. age of child, risk), but the institution retains control over the investments that comprise the mutual funds.[15] Upon making this contribution, some states permit the donor to deduct the amount contributed for state tax purposes.[16] The donor may either make periodic contributions to the fund or simply contribute a lump sum of money, which will be deemed tax-free beginning in the year 2002.[17] When the beneficiary begins college, the donor may make withdrawals exclusively for education expenses. In most states, use of the funds for unqualified purposes will result in a 10% penalty, as well as income tax to be imposed upon the earnings.[18] Additionally, receipt of a scholarship or death of the beneficiary usually permits withdrawal of the funds without the penalty, but the earnings will still be taxed.[19] Although each state statute governs the specific details involved, the QSTP savings plan functions mainly as a simple scheme.

State-sponsored QSTP savings plans are becoming more and more attractive to investors for numerous reasons. First and foremost, the investment grows tax-deferred, and beginning in 2002, the Tax Act will remove the federal income tax on those withdrawals used for education.[20] Prior to the Tax Act, the IRS taxed income at the beneficiary's rate.[21] The beneficiary normally is a child, whose rate is lower than the donor, who is often a parent or grandparent.[22] Another reason these plans are so attractive is that although there is no federal deduction for the contribution itself, beneficiaries can use the QSTP savings plan for just about any post-secondary school expense, such as tuition, room, board, fees, books, transportation, supplies, as well as graduate school.[23] Although donors may contribute up to $265,000 in some state to cover these expenses, contribution caps exist to avoid the creation of large tax shelters for the wealthy.[24] An attractive feature especially for grandparents and other elderly donors is the accelerated gift provision that permits a donor to gift up to $50,000 free of gift tax ($100,000 if married filing joint), assuming that the donor makes no other gifts over the next five years.[25] These benefits explain why over 1.5 million children are presently enrolled in these savings plans, which represents $9.5 billion saved and invested for future education expenses.[26] All income earned in these plans will be exempt from state as well as federal income taxes, assuming the beneficiary uses the income is used for education expenses.[27]

2. Education IRAs

In 1997, an Education Individual Retirement Arrangement ("Education IRA") first offered a taxpayer the opportunity to create a "trust or custodial account created exclusively for the purpose of paying qualified higher education expenses of a named beneficiary."[28] To start an Education IRA, an investor deposits money into a trust or custodial account at a financial institution, where the money grows tax-deferred.[29] Upon withdrawal for qualified tuition expenses, the income earned is not taxed if the withdrawals do not exceed the qualified higher education expenses.[30] These expenses include tuition, fees, books, supplies and equipment required for attendance.[31] Beginning in 2002, the Tax Act will boost the maximum annual contribution from $500 to $2,000 per beneficiary, which will transform the Education IRA into a much more useful savings tool.[32]

Under current law, Education IRA total contributions for a single beneficiary cannot exceed $500, but the Tax Act will increase this amount to $2,000 for each beneficiary.[33] Any excess contributions as of 2002 can be withdrawn penalty-free if done so by May 31 of that year.[34] Contributions must cease by the time the beneficiary turns 18 and total distributions must be made by age 30, which is a limitation not found in QSTPs.[35] The deduction phases out based on adjusted gross income ("AGI") for a single donor have changed from $95,000 to

$110,000 and from $190,000 to $220,000 for married donors. This change is an increase for married individuals from the prior range of $150,000 to $160,000.[36] Any contributions in excess of $2,000 are now charged with a 6% excise penalty. Hence, the donor must be careful when making contributions.[37]

The Tax Act has improved what was once a relatively useless tuition savings tool. One of the best features of an Education IRA is that beginning in 2002, it can be used for everything that a QSTP is used, as well as expenses for secondary and elementary education, public or private education, and even religious schools.[38] Unlike other saving vehicles, a variety of supplies, such as computers and uniforms, are also qualifying expenses for Education IRA proceeds.[39] A few considerable drawbacks still exist, however. The age limitation on contributions and distributions restricts the donor's contribution and the beneficiary's time to use the funds. Despite the increase to $2,000 for an Education IRA, the contribution amount is still relatively limited. Some states, like Rhode Island, permit maximum plan contributions to a QSTP savings plan until the account balance is $265,000.[40] Investing $2,000 for 18 years at 6% interest results in only $36,000 of principal, and only about $26,000 in interest.[41] Starting in 2002, however, the Tax Act will permit an individual to invest in both a QSTP and an Education IRA, whereas the current law imposes a 6% penalty on Education IRA contributions made in the same year with QSTP contributions.[42]

3. Tax credits

Tax credits are available to taxpayers incurring their expenses today, whereas QSTPs and Education IRAs are more for those planning for the future education of their young children. There are two types of federal tax credits: HOPE Scholarship tax credit and the Lifetime Learning tax credit. The Tax Act has changed the tax credits only minimally to permit their coordinated use with an Education IRA and QSTP, although the tax credits may not be used simultaneously for the same student.[43] Although financial planners do not praise the tax credits for helping much because of their low limits, in 1998, the first year of the credits, 4.8 million families realized $3.5 billion in tax relief.[44]

The HOPE Scholarship tax credit provides a nonrefundable tax credit directly against the federal income tax liability for the first $1,000 of tuition and required fees and 50% of the second $1,000 spent during the first two years of post-secondary education.[45] The credit is available for each student, so that a parent with a freshman child and a sophomore child in college can take the credit twice.[46] Because the credit is available per student, a taxpayer may claim the credit so long as she files her own tax return and no one else claims her as a dependent. The HOPE Scholarship tax credit phases out for single filers beginning at $40,000 up to $50,000 and for those married filing jointly from $80,000 to $100,000.[47] The student must be pursuing a degree or other recognized educational credential, as well as be enrolled at least half-time for at least one academic period beginning during the taxable year.[48] Furthermore, only those students without a felony drug conviction should apply because that conviction precludes a student from taking the deduction.[49]

The Lifetime Learning tax credit is not drastically different from the HOPE Scholarship tax credit. The major difference is that the Lifetime Learning tax credit is available per tax return.[50] Thus, regardless of how many children are in school, the taxpayer may only take one credit on their tax return. Like the HOPE Scholarship tax credit, a taxpayer may claim the credit on his own return if no one else claims him as a dependent. One positive aspect of the credit is that it may be taken every year, not just the first two years of school.[51] The amount of the credit is 20% of the first $5,000 spent on qualified education expenses, or up to $1,000.[52] Like the HOPE Scholarship tax credit, the credit phases out for single filers beginning at $40,000 up to $50,000 and for those married filing jointly from $80,000 to $100,000.[53] A benefit attributed to the Lifetime Learning tax credit is that it can be used for students who are pursuing any course of study.[54] Thus, a taxpayer can take a single course to learn new skills or improve existing skills and is still able to take the credit.[55] Finally, the drug felony conviction rule of the HOPE Scholarship tax credit does not apply to the Lifetime Learning tax credit.[56]

4. § 222 Deduction for Higher Education Expenses

The § 222 deduction for higher education expenses ("§ 222 deduction") is the only new education expense assistance, as all the other Tax Act changes were to preexisting credits and programs. Section 431 of the Tax Act provides for a new Internal Revenue Code ("IRC") § 222 "Qualified Tuition and Related Expenses," which permits an above-the-line deduction for the years 2002 through 2005.[57] The deduction in 2002 and 2003 will be $3,000 up to $65,000 of AGI for single filers and $130,000 for joint returns.[58] For 2004 and 2005, the deduction will be $4,000, which disappears at the same AGI levels.[59] However, in 2004 and 2005, § 222 will also provide for a $2,000 deduction for AGI up to $80,000 for single filers and $160,000 for joint returns.[60] The deduction may be used against "qualified tuition and related expenses," which includes only tuition and fees, like a HOPE Scholarship tax credit.[61] Like QSTPs and Education IRAs, § 222 requires coordination of benefits, which means a taxpayer cannot take an itemized deduction to maintain or improve job-related skills while also taking a deduction under § 222.[62] Also, a taxpayer cannot use the § 222 deduction with either tax credit. Additionally, it must be coordinated with an Education IRA and QSTP savings plan distribution to ensure that the tax-free income plus the § 222 deduction taken does not exceed the aforementioned limits under § 222. Lastly, the deduction is based on amounts paid during the tax year beginning in 2002.[63] Thus, a taxpayer should try to postpone making 2002 spring tuition payments until January.[64] Because the deduction expires at the end of 2005, the taxpayer should try to prepay tuition for the spring of 2006 school year and take the § 222 deduction on their 2005 tax return.[65]

5. Deductible School Loan Interest

The only tax break offered to students upon completion of their education is the deduction for interest on their school loans for the sixty months, or five years, after they have completed their education.[66] Beginning in 2002, however, the Tax Act will eliminate this sixty-month period, which benefits almost all students, given that most loans have repayment periods of ten to thirty years.[67] The rules placed on this deduction require that the student must have been enrolled at least half-time in a program that could lead to a degree, certificate, or other recognized educational credential.[68] The taxpayer must file either single or married filing jointly, but the taxpayer need not itemize his deductions.[69] Upon taking out the educational loan, the taxpayer must be either the student, the spouse of the student, or a dependent of the taxpayer.[70]

There are several limitations on this deduction, which every taxpayer should know, the most important being the limit on AGI. Through 2001, the phase-out for single filers is from $40,000 to $55,000 and $60,000 to $75,000 for married filers, and beginning in 2002, the phase-out range will be from $50,000 to $65,000 for single filers and $100,000 to $130,000 for married filers.[71] Also, the loan cannot come from a related person or a qualified employer plan.[72] Third, the deduction cannot be taken if it is taken elsewhere on the tax return.[73] That is, if the taxpayer took a home equity loan and used the proceeds for education, that taxpayer may either take the itemized deduction for home equity loan interest or the education interest, but not both.[74] Lastly, the loan proceeds received within sixty days of the beginning or end of the academic period. However, this rule applies only if the relevant loan was not part of a federal loan program.[75]

C. Conditions and Limitations of Education Tax Breaks

1. § 529 Plans (QSTPs)

Since education prices rose as much as 440 percent from 1976 to 1996, and the median household income only rose 82 percent over that same period, these cost cutters are obviously important.[76] From 1980 to 1995, the U.S. Department of Education's loan portfolio increased from $2.2 billion to $11.5 billion.[77] Moreover, the percentage of post-secondary students with loans upon graduation increased from 41 percent during the 1992-93 school year to 52 percent during the 1995-96 school year.[78] Given these statistics, average consumers should be very interested in getting their piece of the tax break pie. Before donors write a check to anyone, however, it is important to flush out some potential problems for the uninformed.

QSTP prepaid tuition plans and savings plans are very popular these days for their tax-free growth at both the state and federal level, but they do have valid areas of concern. One concern is that the availability of more tax-free money will encourage colleges to increase their tuition.[79] In 1999-2000, however, the second year for the two tax credits, the average cost of attending college increased only 3.4 percent at public schools and 4.6 percent at private schools, which shows that tax breaks did not cause tuition hikes.[80] This increase was the lowest in the last 12 years.[81] Tuition increases averaged five percent for each of the past several years.[82] Nonetheless, a financial aid package usually decreases when a beneficiary applies for financial aid because the QSTP is considered an asset available for tuition expenses.[83] Moreover, the child's income for purposes of reassessing financial need in following years includes the income component of a withdrawal.[84]

Another concern in light of the terrorist attacks in New York City is that the value of savings plans will drop due to their investment in the stock market. While participants receive a selection of funds, depending on the state, aggressive or risky funds could not only remain stagnant but may decrease in value, which would defy the whole purpose of the savings plan.[85] One option for a declining fund value is to rollover the account into another state's more conservative plan.[86] This maneuver is done tax free, and is also useful as more and more states open savings plans with numerous options, like a wider variety of funds and higher contribution caps.[87]

A third problem is that the beneficiary has no control over the distributions, which means a dispute between father and son, for example, could result in the son's sudden lack of tuition in the middle of his sophomore year.[88] Although this may not be a problem for parents, the beneficiary is inevitably in a delicate situation. A similar problem arises when a company is the donor for an employee's child so long as the employee remains with the company.[89] In this situation, an employee must stay in a potentially bad job situation for fear of losing his child's tuition money.[90]

Another limitation applies to those choosing to take advantage of the accelerated gift provision. In particular, participants should be aware that if the donor dies before the five years elapse, the pro rata portion of the gift is still included in his estate.[91] In other words, if a grandmother gives $50,000 in year one but passes away in year three, a pro rata portion of that gift (i.e. $25,000) will be included in her estate. Thus, an estate is not completely safe from taxes when an untimely death removes the tax benefits from an accelerated gift.

Regarding the prepaid tuition credits, another concern arises. Although donors buy credits for a particular school, there is no guarantee that the student will be admitted.[92] Also, if a student chooses not to go to a state school, in most states he will not receive the full value of the prepaid tuition contract as he would have had he attended a state school.[93] In Illinois, for example, prepaid credits may be used for private or out-of-state universities, but the student will only receive the current average mean-weighted credit hour value of registration fees purchased under the contract, less a transfer fee.[94]

2. Education IRAs

The Tax Act significantly improved the utility of the Education IRA, which was once so limited as to be almost useless. A smart investor should remember a few traps in order to avoid tax penalties. While there is no penalty beginning in 2002 for contributions to both an Education IRA and a QSTP, the 6% excise penalty for contributions over $2,000 could be an unpleasant surprise. The IRS imposes the penalty on contributions for the current year in addition to any excess from prior years for a single beneficiary, and that excess over $2,000 is not withdrawn by the time the return is filed.[95] The donor should coordinate with other donors to the Education IRA to ensure that total donations do not exceed $2,000. Knowing if these other donors exist is yet another trick underlying the Education IRA. Also, beneficiaries should remember that if they do not use the funds by their 30th birthday, they are not only taxed on the earnings as income, but there is a 10% penalty on top of the income tax.[96] This limitation could create a problem for those who attend school later in life. The Tax Act does, however, permit a tax-free rollover to another family member of the beneficiary.[97] Such financial details are tricky to remember and a possible motivation to avoid the Education IRA, especially in light of the benefits derived from a QSTP. One other characteristic of the

Education IRA is that it becomes property of the beneficiary to make withdrawals when necessary.[98] Thus, the beneficiary can decide that going to Jamaica is more important than going to college and the donor can do nothing about it. Although Junior will pay the 10% penalty and income tax on earnings, that consequence might not bother a free-spirited eighteen year-old.

3. Tax credits

The panoply of problems with tax credits is as vast as it is frustrating. Despite the Tax Act, neither tax credit really provides the intended relief for which it was created: to help lower income families finance a college education. The problem is that because the credit is non-refundable, a taxpayer must have at least $20,000 of taxable income as a single taxpayer and $25,750 of taxable income if married filing jointly in order to have a tax liability of $1,500.[99] This income requirement seems to negate the intent to help the low-income earners. Given that the average 1999-2000 tuition, room, and board costs total $8,086 at a public institution and $21,339 at a private institution, the HOPE Scholarship tax credit does not actually give much hope to the intended beneficiaries.[100]

The Lifetime Learning tax credit also has its share of drawbacks. First, because it is per return and married people must file jointly to take the credit, married people can only take it once regardless if both are in school; this limitation is similar to a marriage penalty.[101] Second, like the HOPE Scholarship tax credit, a $1,000 non-refundable tax credit will do little to help the low-income taxpayers. On the brighter side, the credit increases to 20% of $10,000 in 2003, thus doubling the credit to $2,000.[102] Alternatively, the credit retains the problem of requiring higher income to get full benefits because the Lifetime Learning credit is non-refundable.

The two tax credits also share some common problems. First, the definition of "qualified educational expenses" is rather narrow because it only includes tuition, academic fees, books, supplies, and equipment.[103] Thus, unlike the Education IRA and QSTPs, the credit does not cover the expensive room and board, transportation, and other personal expenses. This limitation can be a problem for a student attending a school like University of California at Berkeley, where in-state tuition is $15,642, of which $9,448 is not a "qualified educational expense."[104] Another problem with both the HOPE Scholarship and the Lifetime Learning tax credits is that the two cannot be used simultaneously for the same student, although both can be used if there are two qualifying students, like a sophomore and junior who are both dependents of the taxpayer.[105]

4. § 222 Deduction for Higher Education Expenses

As with all the other tax programs to help the taxpayer, the individual should be aware of some loopholes and limits regarding the § 222 deduction. Like the Lifetime Learning tax credit, the § 222 deduction is only available per taxpayer, so regardless if a parent has one child or three children in school, he will only receive $3,000 maximum in 2002 and 2003.[106] The § 222 deduction ceases at $65,000 for the single taxpayer, whereas the two tax credits begin their phase out at $40,000.[107] Because taxpayers must choose between tax credits or the § 222 deduction, single taxpayers with AGI under $40,000 will likely take the HOPE Scholarship or Lifetime Learning credit directly against their tax liability rather than a deduction, which merely lowers AGI. Thus, low-income individuals will not take the credit despite the deduction's original purpose to help them.[108] Middle-income people, however, will likely utilize this credit because they are usually ineligible for the tax credits. Additionally, the § 222 deduction must coordinate with the Education IRA and QSTP to avoid double benefit, and the coordination of when to use each benefit can be a challenging calculation for the average taxpayer without a financial planner.[109] Therefore, a taxpayer withdrawing $5,000 from an Education IRA, which includes $4,500 of principal and $500 of tax-free income, may only take $2,500 of a § 222 deduction. This result is because the $3,000 § 222 deduction is reduced by $500 of tax-free income from the Education IRA. The record-keeping necessary to ensure compliance with § 222 is tricky and likely to ensnare the taxpayer in the IRS web of confusion and possible penalties.

5. Deductible School Loan Interest

The loan interest deduction provides needed relief that was not included in the 1986 Tax Reform Act, but it too has some faults. Given that the average graduate student has $50,000 of debt upon completion of their degree, a $2,500 deduction may not be exceptionally helpful.[110] Also, the low AGI limitations essentially preclude the middle class from taking any deduction because a single parent starts to lose the deduction at $50,000, or $100,000 for those married filing jointly.[111] As with other benefits, the deduction must coordinate with Education IRA distributions and employer-paid education benefits because a taxpayer cannot receive double benefits.[112] Lastly, only the individual legally obligated to repay the loan is entitled to the deduction.[113] Thus, upon applying for a loan, the taxpayer should take into consideration the expected AGI of the student during repayment.[114] For example, if the donor thinks the beneficiary will make a lot of money when he is done with college, she should take the loan in her name because his AGI will likely preclude him from taking the deduction upon graduation.

D. Conclusion

"What a tangled web of rules they weave, when they practice to relieve," or so a financial bard might have written about Congress' attempts to help students. The taxpayer with hopes of higher education should take heart because there are genuine benefits buried in the Tax Act to help with the financial baccalaureate burden. Decisions made today should focus on where the student is in life. The parent of a child in kindergarten should focus more on the QSTPs and Education IRAs, whereas a parent of a current college student would find more relief in the tax credits and the § 222 deduction. These plans permit the donors to let their money grow tax free, and the investment options among savings plans are broadening all the time. Also, every state has either a QSTP savings plan or prepaid tuition, or is in the process of developing a QSTP. Lastly, the increased limit on an Education IRA makes it much more useful than before the Tax Act, and its proceeds cover the widest variety of education expenses.

Second, taxpayers should not rely on current credits and deductions for future expenses because the government can give and take its tax breaks depending upon the parties in power and the availability of relief. With the September 11th tragedy in New York City and Washington D.C., Congress allotted a significant amount of money that was possibly marked as tax relief dollars back in June, including $15 billion for airline relief alone.[115] It is therefore difficult to say what the future holds in terms of tax relief, and a youngster's parent should not rely on tax credits and deductions as the sole means of making education more affordable. Moreover, parents should carefully study the credits upon paying for college now because of the risk of taking double benefits, which is not allowed under the Code.[116] Parents with multiple children in school should use the HOPE Scholarship tax credit first because it is only available for the first two years of college. Additionally, Lifetime Learning tax credit is available per taxpayer, not per student like the HOPE Scholarship tax credit. These factors are important to remember to maximize the benefits and minimize the penalties and lost benefits.

Third, the § 222 deductions and loan interest deductions provide added relief, although the conditions and rules make them seem more of a burden than the limited benefit they provide. Consumers must be aware of their AGI levels and use of other deductions and benefits just like an Education IRA and both tax credits. Nonetheless, these deductions do provide some relief to the taxpayer who is willing to jump the hurdles. Although the § 222 deduction directly lowers taxes by reducing the tax base, the § 222 deduction also indirectly reduces taxes because a lower AGI affects other deductions like miscellaneous itemized deductions that must exceed two percent of AGI.[117]

The government and financial advisors enthusiastically spread the word about the tax benefits of the new Tax Act and the various plans offered. The smart consumer, however, must realize that there are limits on what the Tax Act will and won't do. The rules, conditions and limitations placed on QSTPs, Education IRAs, tax credits, and deductions confuse even the experts. Thus, careful planning and research are necessary to help consumers understand what they can expect in terms of education expense relief, and how to avoid IRS penalties, missed benefits, and possibly lost investment. With an understanding of the profits as well as the pitfalls of the Tax Act, the savvy taxpayer will learn that education need not be as expensive as it is today.

Summary of Significant Considerations for Education Expenses under the Tax Act beginning in 2002

	Benefits	Drawbacks	Other Considerations
QSTPs **Prepaid Tuition**	Lock-in today's tuition rates Can use with Education IRA	Limited transferability May not get full benefits if student attends out-of-state or private school	Not widely available to non-residents
Savings Plans	Tax-free growth Broad use of funds Accelerated gifting provision Can use with Education IRA Donor can get $ back with little penalty	Subject to market fluctuations No control over investments	Donor's property Will affect financial aid Maximum contribution varies from state to state
Education IRA	Broadest use of funds Increased from $500 to $2,000 Can deduct contributions Can use with QSTP savings plan	Age limits (18 to contribute & 30 to use) Lower investment cap than savings plan	Phase-out: Single:$95,000-$110,000 Married:$160,000-$220,000 Beneficiary's property at age 18
Tax Credits **HOPE Scholarship**	Per student Tax credit reduces tax liability dollar for dollar	Only 1st 2 years Small credit Non-refundable No drug felons Must be at least _ time Only for degree-seekers Only tuition & fees Must coordinate with other tax benefits	Phase-out: Single:$40,000-$50,000 Married:$80,000-$100,000
Lifetime Learning	Used during any year of schooling Used for any course of study Tax credit reduces tax liability dollar for dollar Available to drug felons	Per return Small credit Non-refundable Only tuition & fees Must coordinate with other tax benefits	Phase-out: Single:$50,000-$65,000 Married:$110,000-$130,000
§222 Deduction	Only new tax benefit No need to itemize to utilize	Low deduction limit Only for 2002-2005 Must coordinate with other tax benefits	<u>$3,000 deduction</u> No deduction at AGI of: 2002-2003: single $65,000 married $130,000 <u>$4,000 deduction</u> 2004-2005:single $65,000 married $130,000 <u>$2,000 deduction</u> 2004-2005:single $80,000 married $160,000
Loan Interest Deduction	Can use for entire payback period (not 60 months) No need to itemize to utilize Only benefit available after education is complete	Only for degree-seekers Must be at least _ time Student must be taxpayer, taxpayer's spouse or dependent	Phase-out: Single:$50,000-$65,000 Married:$100,000-$130,000

Coordination of Tax Benefits Under the Tax Act Beginning in 2002

	QSTP Prepaid Tuition	QSTP Savings Plan	Education IRA	HOPE Scholarship Tax Credit	Lifetime Learning Tax Credit	§222 Deduction
QSTP Prepaid Tuition		Can have both, but prepaid credits are usable only at the relevant school system.	Fully usable	Must coordinate so tax-free income from QSTP does not exceed credit.	Must coordinate so tax-free income from QSTP does not exceed credit.	§222 & withdrawn tax-free income cannot exceed §222 limit
QSTP Savings Plan	Can have both, but prepaid credits are usable only at the relevant school system.		Fully usable	Must coordinate so tax-free income from QSTP does not exceed credit.	Must coordinate so tax-free income from QSTP does not exceed credit.	§222 & withdrawn tax-free income cannot exceed §222 limit
Education IRA	Fully usable	Fully usable		Must coordinate so tax-free income from IRA does not exceed credit.	Must coordinate so tax-free income from IRA does not exceed credit.	§222 & withdrawn tax-free income cannot exceed $2,000
HOPE Scholarship Tax Credit	Must coordinate so tax-free income from QSTP does not exceed credit.	Must coordinate so tax-free income from QSTP does not exceed credit.	Must coordinate so tax-free income from IRA does not exceed credit.		NOT usable together for same student	NOT usable together
Lifetime Learning Tax Credit	Must coordinate so tax-free income from QSTP does not exceed credit.	Must coordinate so tax-free income from QSTP does not exceed credit.	Must coordinate so tax-free income from IRA does not exceed credit.	NOT usable together for same student		NOT usable together
§222 Deduction	§222 & withdrawn tax-free income cannot exceed §222 limit	§222 & withdrawn tax-free income cannot exceed §222 limit	§222 & withdrawn tax-free income cannot exceed $2,000	NOT usable together	NOT usable together	
Loan Interest Deduction	Because the loan interest deduction is used AFTER the education is complete, and the other benefits are used DURING the education, the loan interest deduction will never be taken at the same time as the other tax benefits.					

[1]*Tax Incentives to Promote Saving for Higher Education Before the Committee on Ways and Means, U.S. House of Representatives*, 105th Cong. 1st Sess. (1999) (statement of Marshall Bennett, State Treasurer of

Endnotes

1. *Tax Incentives to Promote Saving for Higher Education Before the Committee on Ways and Means, U.S. House of Representatives,* 105th Cong. 1st Sess. (1999) [hereinafter Bennett] (statement of Marshall Bennett, State Treasurer of Mississippi on June 23, 1999). As the first state to help its citizens with education expenses, New Jersey offered college savings bonds in 1959.

2. U.S. Senator Charles Schumer, (D-NY), Statement at U.S. Senator Thomas Daschle's (D-SD) News Conference on Taxes, 107th Cong. 1st Sess. (2001) (May 17, 2001) (transcript available at FDCH Political Transcripts; copyright 2001 eMediaMillWorks, Inc).

3. *College Cost Facts & Myths: College May Cost Less Than You Think, available at* http://www.collegeboard.com/article/0,1120,6-29-0-396,00.html (last visited Sept. 6, 2001). This website cites to the College Board's *Trends in College Pricing 2000* and *Straight Talk About College Costs and Prices,* from the "Report of the National Commission on the Cost of Higher Education" from January 1998.

4. *Id.*

5. Bennett, *supra* note 1, at 3.

6. Amy J. Oliver, *Improving the Tax Code to Provide Meaningful and Effective Tax Incentives for Higher Education,* 12 J. L. & Pol'y 91, 119 (2000) [hereinafter Oliver] (citing to Joint Committee on Taxation, 105th Cong.); General Explanation of Tax Legislation Enacted in 1997, at 24 (Comm Print 1997). IRC § 529 was originally enacted as part of the Small Business Job Protection Act of 1996 and established tax-exempt status for QSTPs.

7. LA. REV. STAT. ANN. § 17:3095(A)(1)(a) (West 2001). This law requires "Either the depositor or beneficiary must be a Louisiana resident when the agreement is initiated" for its savings plan. Louisiana does not have a prepaid tuition plan.

8. Bennett, *supra* note 1, at 3.

9. KY. REV. STAT. ANN. § 164A.700(5) (Banks-Baldwin 2001); *see also* http://www.kytreasury.com/KAPT/kapthome2.htm (Kentucky's state website for its prepaid tuition plans).

10. COLO. REV. STAT. § 23-3.1-206.7; *see also* http://www.collegeinvest.org (Colorado's state website for its college savings plans). *See also* http://www.savingforcollege.com/compare/plan/6.php (providing a valuable summary of Colorado's plan).

11. 110 ILL. COMP. STAT. 979/45(m) (2001); *see also* http://www.collegeillinois.com/faq/coverage (Illinois' state website for its college savings plans). It should be noted that Illinois will pay the "mean weighted average" of tuition charged by comparable public universities, which can be more or less than the cost of the Illinois institution. For those attending private school, it is unlikely that the prepaid tuition credits will exceed the cost of tuition at a private university.

12. I.R.C. §§ 529(a)(3)(C), (c)(3)(C)(i).

13. I.R.C. § 152(a)(1)-(9). The Code includes as qualifying dependent: beneficiary's son or daughter or descendant of either, stepson or stepdaughter, brother, sister, stepbrother or stepsister, father or mother or an ancestor of either, stepfather or stepmother, son or daughter of a brother or sister, brother or sister of the father or mother, son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, sister-in-law or an individual who lived with the taxpayer during the current taxable year.

14. College Savings Plans Network, *Frequently Asked Questions, available at* http://www.collegesavings.org/frequently_asked_questions.html [hereinafter CSPN] (last visited Sept. 20, 2001).

15. Kristin Davis, *Miracle Grow: A Powerful New Mix of Tax Breaks Can Fortify Your College Savings, available at* http://www.kiplinger.com/magazine/archives/2001/September/managing/college.html.

16. Press Release, College Savings Plans Network, *College Savings Programs Receive Tax Exemption, at* http://www.nast.net.Fedl_Ex_PR_6-7-01.html (last visited Sept. 20, 2001).

17. Ann Burstein Cohen, *New Tax Law Provides Challenging Curriculum for College Saving*, TAXES, 17, 23 (2001) [hereinafter Cohen].

18. Joe Hurley, *Frequently Asked Questions, at* http://www.savingforcollege.com/learn/faq.php [hereinafter Hurley] (last visited Sept. 20, 2001).

19. *Id.*

20. *Id.*

21. Oliver, *supra* note 6, at 119.

22. *Id.*

23. CSPN, *supra* note 14.

24. Bennett, *supra* note 1, at 4. Also, note that Rhode Island permits contributions up to $265,000 for their QSTP savings plan. For more information about Rhode Island, see *Frequently asked questions* at http://www.collegeboundfund.com.

25. 26 U.S.C.A. § 529(c) (West Supp. 2001).

26. Peter Schmidt, *Bush Tax Cut Gives New Clout to States' College-Savings Plans*, THE CHRONICLE OF HIGHER EDUCATION, June 22, 2001, at A21 [hereinafter Schmidt].

27. *Id.*

28. Oliver, *supra* note 6, at 114.

29. *Id.*

30. *Id.*

31. *Id.*

32. The College Planner Newsletter, *New Tax Bill Provides Benefits for Education – But Remember to Check the Details, at* http://www.thecollegeplanner.com/sample.html (last visited Sept. 6, 2001).

33. Cohen, *supra* note 17, at 19.

34. Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, 115 Stat. 38 [hereinafter Tax Act].

35. 26 U.S.C.A. §§ 530(b)(1)(A)(ii), (b)(1)(E) (West 2001).

36. Tax Act, *supra* note 34, at § 401(b)(1)-(2).

37. Cohen, *supra* note 17, at 19.

38. *Id.* at 20. Note that the ability to use federal tax-benefited funds has not been permitted for private or religious purposes before the Tax Act.

39. *Id.* This Tax Act is the first step in permitting federal tax relief for elementary and secondary education.

40. Alliance Capital, *Frequently Asked Questions, available at* http://www.collegeboundfund.com (last visited Oct. 27, 2001). Alliance Capital is the investment company managing Rhode Island's QSTP savings plan.

41. Cohen, *supra* note 17, at 19.

42. *Id.*

43. Tax Act, *supra* note 34, at § 402(b)(1), amending § 529(c)(3)(B). "Coordinated use" means that a taxpayer cannot use both an Education IRA and a savings plan and have the tax-free income from both used for the same expense. The taxpayer must calculate the timing to use each benefit to ensure there is no overlap.

44. Oliver, *supra* note 6, at 112, citing statistics from the Joint Committee on Taxation, 106th Cong., 1st Session, Overview of Present Law and Issues Relating to Individual Income Taxes (Joint Comm. Print 1999).

45. 26 U.S.C. § 25A(b)(1)(A)-(B) (West 2001).

46. *Id.*

47. *Id.* at § 25A(d)(1).

48. *Id.* at § 25A(b)(2)(B).

49. *Id.* at § 25A(b)(2)(D).

50. *Id.* at § 25A(c)(1).

51. *Id.*

52. *Id.* "Qualified education expenses" include expenses at any educational institution to acquire or improve job skills of the individual regardless of the student's status as full-time, part-time or less than half-time. This is broader than the HOPE Scholarship tax credit, which requires that the student be at least half-time "in a degree, certificate or other program leading to a recognized education credential at an eligible education institution of higher education." Joint Committee on Taxation, 105th Cong. General Explanation of Tax Legislation Enacted in 1997, at 16 (Comm. Print 1997).

53. *Id.* at § 25A(d)(2).

54. *Id.*

55. *Id.*

56. Internal Revenue Service, PUB. NO. 970, TAX BENEFITS FOR HIGHER EDUCATION for returns in 2000, at 9 (2000) [hereinafter PUB. NO. 970]. This publication is on the Internal Revenue Service website, *available at* http://www.irs.ustreas.gov "Forms and Publications by Number" (last visited Oct. 27, 2001).

57. Tax Act, *supra* note 34, at § 431(a).

58. *Id.*

59. *Id.*

60. *Id.*

61. *Id.*

62. *Id.*

63. Cohen, *supra* note 17, at 26.

64. *Id.*

65. *Id.*

66. Shellie L. Moore, *Student Loan Interest: An Overview of the Student Loan Interest Deduction, at* http://www.taxes.about.com/library/weekly; www.taxes.about.com/library/weekly/aa020801a.html [hereinafter Moore] (last visited Sept. 23, 2001).

67. H.R. 1836 § 412(a). This section of the Tax Act amends I.R.C. § 221 regarding the 60-month time limit to deduct interest on education loans.

68. Moore, *supra* note 66.

69. *Id.*

70. *Id.*

71. Cohen, *supra* note 17, at 27.

72. Moore, *supra* note 66.

73. *Id.*

74. *Id.*

75. *Id.*

76. Bennett, *supra* note 1, at 2.

77. *Id.*

78. *Id.*

79. Schmidt, *supra* note 26.

80. Oliver, *supra* note 6, at 125.

81. *Id.* at 145 n.228.

82. Pamela Bradley, *Educators Say College Tuition Hikes Have Slowed,* USA TODAY, October 5, 1999.

83. Hurley, *supra* note 18.

84. *Id.*

85. Schmidt, *supra* note 26.

86. *Id.*

87. *Id.*

88. Robert P. Perry, *Business Problems & Planning – College Savings Accounts: Golden Handcuffs for the Entire Family?*, 79 MICH BAR JNL. 205, 206 (Feb. 2000).

89. *Id.*

90. *Id.*

91. Cohen, *supra* note 17, at 22, citing § 529(c)(2)(B), which permits the donation of up to $50,000 per individual donor ($100,000 for married donors) to a single beneficiary tax-free. The donor is then precluded from making any more tax-free gifts to that beneficiary over the next five years. Although this is a great way to gift cash to avoid the taxes that would accumulate otherwise on interest and minimize the estate, the taxpayer should be aware that it is possible for the gift to re-enter the estate if the donor dies before five years elapses (or four years if $40,000 was gifted).

92. CSPN, *supra* note 14.

93. Hurley, *supra* note 18.

94. 110 ILL. COMP. STAT. 979/45(m) (2001). Because out-of-state tuition and private tuition tend to be higher than in-state tuition, the student

will likely pay more to cover the difference between actual expenses and Illinois college expenses.

95. PUB. NO. 970, *supra* note 56, at 21.

96. *Id.* Note that withdrawals due to death of beneficiary, receipt of scholarship or disability are subject to income tax, but not the 10% penalty. Rolling the Education IRA over to a young family member is a smart way to avoid the penalty and the income tax.

97. *Id.* A family member includes the beneficiary's son or daughter or descendant of either, stepson or stepdaughter, brother, sister, stepbrother or stepsister, father or mother or an ancestor of either, stepfather or stepmother, son or daughter of a brother or sister, brother or sister of the father or mother, son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, sister-in-law or an individual who lived with the taxpayer during the current taxable year.

98. Internal Revenue Service, PUB. NO. 590: INDIVIDUAL RETIREMENT ACCOUNTS for returns in 2000, *available at* http://www.irs.ustreas.gov/forms_pubs/pubs/p5900304.html (last visited Sept. 23, 2001).

99. This calculation is based on 2000 tax tables, as well as three exemptions for the married filing joint taxpayer (assuming two parents with one child) and two exemptions for the single return (one parent with one child).

100. Oliver, *supra* note 6, at 116.

101. *Id.* at 111.

102. Cohen, *supra* note 17, at 25. Note that due to the credit's non-refundable nature, a taxpayer must have gross income of at least $23,350 for an individual (2 exemptions for one parent and one child) in 2000, and $29,100 for a couple filing jointly (3 exemptions for two parents and one child) in 2000. In order to obtain the full benefit of the credit, the taxpayer must have gross income considerably above the poverty level of $11,250 for a household of two and $14,150 for a household of three. (Source: 2000 Poverty Guidelines Effective for Use with I-864 as of April 1, 2000; http://www.travel.state.gov/00povert.html)

103. Oliver, *supra* note 6, at 129.

104. *Id.* at n. 252-254, citing Berkeley's website *at* http://www.uga.berkeley.edu/ouars/level_2/fin_aid.html.

105. Cohen, *supra* note 17, at 25. A situation with two qualifying students is when there is a freshman and a junior in the same household. However, when those same students are in their junior year and first year of graduate school, the taxpayer will be reduced to only the Lifetime Learning tax credit.

106. *Id.* at 21.

107. *Id.* at 25, 27.

108. *Id.*

109. *Id.* at 26.

110. *Id.* at 27.

111. *Id.*

112. *Id.*

113. *Id.*

114. *Id.*

115. Kate Snow, Dana Bash and Ted Barrett, *Congress Approves $15 Billion Airline Bailout*, CNN Washington Bureau, *at* http://www.cnn.com/2001/US/09/21/rec.congress.airline.deal.html (last visited Sept. 30, 2001).

116. Cohen, *supra* note 17, at 25.

117. *Id.* at 26.