

## **Education Saving Opportunities**

### **Education IRA**

Beginning January 1, 2002 the amount that can be contributed to an Education IRA goes up from \$500 to \$2,000 per beneficiary. And the new act expands the definition of qualified education expenses that may be paid tax free to include elementary and secondary school expenses including tutoring, tuition, books & supplies, room & board, transportation, uniforms, computer equipment, educational software, Internet access, and many other uses. This expanded definition includes public, private or religious schools providing elementary or secondary education (kindergarten through grade 12).

The phaseout range for married couples filing a joint return has been raised to \$190,000-\$220,000 of modified adjusted gross income, also effective January 1, 2002. The phaseout range for individual taxpayers remains unchanged at \$95,000-\$110,000. However, effective for tax years beginning after December 31, 2001, corporations and other entities (including tax exempt organizations) are allowed to make contributions to Education IRA's regardless of the corporation's or entity's income. Note that this is effective for tax years beginning after December 31, 2001. For calendar year corporations this is January 1, 2002 but will be later for fiscal year end corporations and other entities. Neither the Act nor the Committee report explains what the rules are regarding these contributions. For example, we do not yet know whether a corporate contribution is considered a constructive dividend or whether any nondiscrimination rules apply. I suspect that this is unfinished business, which either Congress or the IRS will subsequently address.

Also new is the ability to contribute to an Education IRA up to the due date of the individual's income tax return, not including extensions (April 15<sup>th</sup>). Prior law required contributions to be made during the calendar year. Like all other provisions affecting Education IRA's this takes effect January 1, 2002.

The new Act also created special provisions for “special needs beneficiaries” including the ability to contribute past the beneficiaries 18<sup>th</sup> birthday and not require a deemed distribution once the special needs beneficiary turns 30. “Special needs” is to be defined later by the IRS but is to include individuals who need additional time to complete their education due to physical, mental or emotional conditions (including learning disability).

While prior law did not allow an individual to use the HOPE or Lifetime Learning credit if the beneficiary took a tax free Education IRA distribution, the new act allows a taxpayer to do both as long as the Education IRA money is not used to pay a qualified higher education expense for which the taxpayer is taking the education credit. Can't use the money for the same expense and take the tax-free distribution and the credit. As long as the monies pay different qualified expenses (and the kind of expenses for the credits are limited), taxpayers can have tax free Education IRA distributions and take the education credit beginning January 1, 2002.

Also new for 2002 is that contributions to an Education IRA and contributions to a 529 plan can be made for the same beneficiary. Current law imposes a 6% excise tax penalty on the 529 contributions.

### **Section 529 Plans**

Current law permits contributions to a state sanctioned account established to meet qualified higher education expenses of a designated beneficiary (a “savings account plan”) or to purchase tuition credits on behalf of a designated beneficiary to be used for subsequent payment of qualified higher education expenses of the designated beneficiary. Currently the earnings portions of the distributions for qualified higher education expenses are taxable to the beneficiary. The new act eliminates the distributions from the definition of taxable income and so for federal income tax purposes the distributions for qualified higher education expenses will not be taxable beginning January 1, 2002. This applies only to state programs but does apply to both the “savings plan” and the tuition credit plan. The new act allows the taxpayer to still take one of the education credits on qualified higher education expenses not paid for by the 529 plans. Actually, the new law states that only the earnings from the 529 plans cannot be used for purposes of calculating the education credit.

For example, let's assume the only expense for the year is \$5,000 in tuition. If the 529 plan is currently worth exactly \$5,000 but \$4,500 was originally contributed the earnings represent \$500. If the full amount of the 529 plan is used to pay the tuition, \$4,500 is eligible for the education credit even though the entire 529 plan was used to pay the tuition. While you can't decide how to split out the earnings from the return of your contributions (this is done by spreading out earnings and return of contributions over all distributions based upon the percentage of earnings to the total value of the 529 plan) it is important to weigh what expenses will be paid from what pot.

Added to the Act was the ability by private institutions to set up 529 plans but only for the tuition credit portion of the plan. This is also effective January 1, 2002. Distributions during 2002 and 2003 for qualified higher education expenses are includable in taxable income to the extent of earnings but without penalty. After January 1, 2004 none of the distributions used for qualified higher education expenses will be subject to federal tax. And again, qualified higher education expenses not paid by either an Education IRA or distribution from a 529 plan are eligible for one of the education credits. That same example I gave previously applies here as well.

529 plans, unlike Education IRA's, have no phaseout rules as it relates to the contributor's adjusted gross income and are not restricted to beneficiaries under the age of 18. You can establish such a plan to benefit any member of your extended family, including yourself.

There is a wealth of excellent information on 529 plans on the Internet and from your financial planner. However, once you begin to plan for the payment of college expenses you will need to become very familiar with the options available so as to maximize your tax savings. While I might be a shade biased, prior to the first distribution, you should be consulting with your tax advisor. Certain expenses only qualify for certain credits or deductions. Use of the wrong pot of money can leave you with less tax relief than you were entitled to. And at tax time you will need to have a record of all distributions from all sources (including your own pocket) and what type of expense they paid for. It may save you some money.

As a cautionary note, you can only rollover the amount in a 529 plan once in any 12-month period. This is not the same as once a year. Moving the account from one plan to another could have very negative tax implications for you. Before attempting any rollover you would be well served to check with your tax advisor.

### **A New Deduction for Education Expenses**

Effective January 1, 2002 taxpayers may be eligible to deduct from income a portion of fees paid for tuition and other qualified related expenses (as defined by the rules for education credits) directly from their income. This is an above the line deduction (meaning you don't have to itemize to take the deduction) subject to certain income phaseout limits (if you make too much you don't get the deduction, just like the education credits).

The maximum deduction for 2002 & 2003 is \$3,000. This amount increases to \$4,000 for 2004 & 2005. After December 31, 2005 the deduction expires. The deduction is only good for qualified expenses during 2002 to 2005. The deduction is phased out for taxpayers above a certain limit and it is not available to married filing separate taxpayers, dependents, and certain nonresident alien spouses. The amount of the deduction is reduced by the amount of interest excluded from income from U.S. Savings Bonds, the earnings portion of 529 plans, and all distributions from Education IRA's.

The income limitation is based upon "modified adjusted gross income" which requires the adding back of certain nontaxable sources of income. Undoubtedly, the IRS will develop another worksheet that will make the worksheet for filling out page 2 of Schedule D seem like an elementary school reader.

Taxpayer cannot take an education credit and the deduction for the same student in the same year. While credits are generally better, it may be that lower adjusted gross income results in more tax savings. Such a case would occur with low income taxpayers hoping to maximize Earned Income Credit and high income taxpayers who needed a lower taxable income in order to minimize the impact of AMT (Alternative Minimum Tax) where a regular tax

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credit was not helping them. Obviously, at tax time a scenario needs to be run each way to determine which gives you the greatest tax savings.

The changes in tax treatment of education expenses have added a great deal of complexity to an already complex issue. You will need to keep track of all distributions from Education IRA's, 529 plans, and your own out of pocket expenses. Each distribution will have to be matched with the related expense that it paid for, making sure the expense qualified. You will also have to keep track of the earnings within the 529 plans along with the fair market value of the plan each time you make a distribution. Each expense has to be matched to the source of funds. Ideally before you begin distributions you will have a budget that allows your tax advisor to match certain funds with certain expenses in order to maximize your tax savings.

### **Student Loan Interest Deduction**

Current law allows taxpayers within certain income guidelines to deduct interest on student loans only within the first 60 months in which interest payments are required. Effective January 1, 2002 student loan interest, whether required or voluntary, is deductible up to the current \$2,500 maximum per year, regardless of how long you have been paying on the student loan. The phaseout range is moved up and the phaseout range has been expanded. In 2002 the phaseout range is \$50,000-\$65,000 for individual taxpayers and \$100,000-\$135,000 for married filing joint. The phaseout range is indexed for inflation.

### **Employer Provided Educational Assistance**

The Act makes permanent (or until the Act expires in 2011 or until Congress changes its mind) the employer provided educational assistance program and allows it to be used for graduate level education. The current limit of \$5,250 annually remains unchanged. This change is effective January 1, 2002.

If you have questions about these changes please call me at the office or drop me an email. I know that this section is convoluted at best. I expect to spend a fair amount of time this year in classes attempting to make sense of all that the Congress did in this new Act.

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