

# **EDUCATION TAX BENEFITS**



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## COURSE DESCRIPTION

### One Big Beautiful Bill Act (OBBBA)

#### *Annual Inflation-Adjusted Tax Amounts*

Our CPE courses are updated regularly. However, tax legislation passed in the interim period may complicate tax planning and preparation.

You can access the most recent updates to annually adjusted inflation amounts in the following supplement:

<https://cerifi.widen.net/s/ghg5l6mgns/inflation-adjusted-amounts>

You can also access highlights of recent tax legislation at:

<https://cerifi.widen.net/s/fqns2xszwf/highlights-of-recent-tax-provisions>

These documents will be updated periodically.

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#### **Course Description**

Few advantages are as sought after by parents for their children than an education that will enable them to grow professionally and enjoy the benefits such an education can help bestow. The federal government supports and encourages their efforts to provide that education through various programs and income tax incentives.

This course will examine the programs, credits, deductions and federal income tax treatment of various items that affect saving for and financing an individual's education. In so doing, it will consider:

- Qualified tuition programs;
- Coverdell education savings accounts;
- Education savings bond program;
- Federal tax credits for education;
- Federal tax treatment of scholarships, fellowships, grants, and tuition reductions; and
- Federal tax deduction for student loan interest for education loans.

## Learning Objectives

Upon completion of this course, you should be able to:

- Describe the features of the types of qualified tuition programs available under IRC section 529
- Explain the tax benefits provided under an IRC section 529 qualified tuition program
- Identify the limits and tax treatment of contributions to and distributions from a Coverdell education savings account
- Describe the tax treatment of interest earned under qualified U.S. savings bonds used to pay certain education expenses
- Explain the American opportunity and lifetime learning credits
- Illustrate the tax treatment of scholarships, fellowships, and other types of educational assistance
- Explain the tax rules applicable to student loan interest, tuition and fees, and student loan cancellations and repayment assistance

# CHAPTER 1 - 529 QUALIFIED TUITION PROGRAMS

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## Introduction

Education and income are highly correlated. On average, an individual with a bachelor's degree may expect an annual income about twice that of an individual armed only with a high school diploma-and that gap, in terms of both percentage and income, appears to be widening. In order to enable more students to obtain increased levels of education - and, thereby, participate in the benefits that have traditionally followed higher levels of education - the federal government passed laws to facilitate its financing.

Accordingly, important legislation was passed in the decade of the 1990s designed to permit taxpayers to make contributions to a tax-exempt plan whose contributions and earnings would be used to pay qualified higher education expenses. These tax-exempt plans have come to be referred to as IRC §529 qualified tuition programs.

This chapter will examine IRC §529 qualified tuition programs. In so doing, it will consider the types of qualified tuition programs, the nature of qualified education expenses, the types of educational institutions whose expenses may be considered "qualified" and the tax treatment of contributions to and distributions from such plans. Recent legislative updates have expanded the scope of §529 qualified tuition programs to cover pre-college tuition, apprenticeships and even student loan balances (limitations apply).

## Chapter Learning Objectives

When you have completed this chapter, you should be able to:

- Compare prepaid tuition plans with college savings plans;
- Identify the expenses considered qualified education expenses under a qualified tuition program and the educational institutions at which such expenses may be incurred;
- Recognize the rules applicable to IRC §529 qualified tuition program contribution limits and the tax treatment of plan contributions; and
- Apply the applicable tax law to IRC §529 qualified tuition program distributions.

## Qualified Tuition Programs

Qualified tuition programs are programs offered by each of the 50 states and the District of Columbia pursuant to which a taxpayer may contribute funds for the purpose of paying a designated beneficiary's qualified education expenses at a qualified educational institution. In addition, a consortium of private colleges offers a prepaid tuition plan referred to as an independent 529 plan. Like other "qualified" plans - plans such as 401(k) plans, pension plans, etc.- qualified tuition programs offer participants certain federal tax benefits and, depending upon the state, may also offer additional state tax benefits. (See Appendix A for the state tax treatment of §529 plans.)

A qualified tuition program may take one of two forms:

- A prepaid tuition plan; or
- An educational savings plan.

Let's briefly consider each of these qualified tuition program approaches.

## Prepaid Tuition Plans

Under a prepaid tuition plan, a taxpayer pays now for future education. Thus, a taxpayer may lock in the costs of attending college - college attendance that might not occur for many years in the future. Such prepaid tuition plans may be:

- Prepaid unit plans, under which a taxpayer purchases units representing a fixed percentage of tuition. For example, one unit may represent 1% of a year's tuition. In such plans, although every purchaser pays the same price, the price of a prepaid unit generally increases annually; or
- Contract plans, under which a taxpayer agrees to purchase a specified number of years of tuition. Contract plans are generally priced so that the purchase price is smaller when the plan beneficiaries are younger children. Such contract plans assume that, when plan beneficiaries are younger children, more time is available to invest the funds before the beneficiary actually attends college.

Prepaid tuition plans offer a number of advantages. Principal among their advantages is that they:

- Provide a hedge against inflation by permitting taxpayers to effectively pay for future education at current rates;
- Offer guarantees against the need to pay increased tuition;
- Involve little or no risk; and
- Normally outperform traditional savings approaches.

Although prepaid tuition plans clearly offer several significant advantages, they may also involve certain drawbacks.

Important among those drawbacks are the following:

- Participation in a prepaid tuition plan may be available only to state residents;
- If the beneficiary attends a private college or a college outside the state in which the plan is established, the amount contributed to the plan may be insufficient to cover the college costs;
- Alternative approaches- education savings plan, for example - may offer the taxpayer an increased return over an extended time period;
- Withdrawal from a prepaid tuition plan could result in the imposition of a cancellation fee and/or a loss of interest; and
- A prepaid tuition plan may adversely affect the amount of financial aid available to the beneficiary.

## EDUCATION Savings Plans

Not surprisingly, education savings plans are different from prepaid tuition plans. Unlike a prepaid tuition plan, an education savings plan does not permit a taxpayer to purchase future education. Instead, such a taxpayer invests money into a special account established for a designated beneficiary.

Earnings on the funds invested in an education savings plan are tax-deferred and may be entirely tax-free if used to pay qualified education expenses. The balance in an education savings plan may be used to meet qualified education expenses at any accredited U.S. college or university without the need to recognize any income.

In years prior to 2018, education savings plans were called college savings plans and the funds could only be used on post-secondary education expenses. As of 2018, the plan was expanded to allow funds to be spent on pre-college education at qualifying elementary, secondary, and religious schools. With the 2019 passage of the SECURE Act, education savings plan funds can also be used for apprenticeship programs registered through the Department of Labor, and to pay back qualified school loan debt (limitations apply).

Education savings plan advantages include:

- Administrative simplicity, since education savings accounts are easy to establish and are managed by professionals;
- Control of the plan remains with the contributing taxpayer irrespective of the beneficiary's age;
- Flexibility, since no rules prescribe when assets must be used or accounts established;
- Financial aid for which the student would be eligible may be unaffected by the education savings plan since plan assets belong to the contributing taxpayer rather than the student;
- Funds can be used for pre-college expenses and apprenticeship programs; and
- Plan funds may be used to pay back qualified private and federal student loans, including loans for a beneficiary's siblings (limitations apply).

The drawbacks of an education savings plan, when compared with a prepaid tuition plan, include the following:

- The contributing taxpayer bears the investment risk associated with the account;
- There is no guarantee that the education savings plan fund will be sufficient to pay the beneficiary's college costs at the time used;
- Account fees imposed tend to diminish the account's total returns; and
- Full disclosure by the plan may not be required.

## SECURE ACT of 2019

At the end of 2019, the Setting Every Community Up for Retirement Enhancement Act was passed. The SECURE Act expanded several provisions related to education saving plans under §529. The SECURE Act introduced the following changes retroactive to January 1, 2019:

- Expanded the \$10,000 allowance of funds that can be used for pre-college education expenses at elementary, secondary, and religious schools.
- Provides for the payment of up to \$10,000 of qualified student loan debt (both private and federal). This benefit can be used for the beneficiary of the plan, as well as for each eligible sibling of the beneficiary.
- Allows plan funds to be used to pay qualified expenses for apprenticeship programs registered through the Department of Labor.

### Limits on Contributions

Contributions to a qualified tuition program may be made by anyone, regardless of income. Furthermore, the contributing taxpayer need not have a relationship with the designated beneficiary.

Although individual state education savings plans may impose specific dollar limits on the amount of contributions that may be made for a designated beneficiary—\$250,000, adjusted annually for inflation, for example—federal law is less specific. Under federal guidelines, the contributions made to a qualified tuition program for any beneficiary cannot be more than the amount required to provide for the beneficiary's qualified education expenses. A taxpayer may contribute to both a qualified tuition program and a Coverdell education savings account. (Coverdell savings accounts are discussed in Chapter 2.)

Several rules affect qualified tuition programs. Those rules impose the following restrictions on such plans:

- Contributions may only be made in cash. Contributions of securities or other forms of property are not permitted;
- A separate accounting must be maintained for each designated beneficiary;
- Neither a designated beneficiary nor a contributing taxpayer is permitted to direct the investment of contributions or earnings, except that a contributor may change the investment strategy once each calendar year and at any time a beneficiary designation is changed<sup>2</sup>; and
- A plan may not permit any interest in the program to be used as loan collateral.

## Tax Treatment of Qualified Tuition Programs

The tax treatment of a qualified tuition program affects contributions to the program and distributions from it. And, in the case of an education savings plan, the program's tax treatment involves any gain earned on contributions.

Accordingly, we will look at the tax treatment of:

- Contributions to a qualified tuition program;
- Earnings on education savings program contributions; and
- Distributions from a qualified tuition program.

### Qualified Tuition Program Contributions Not Deductible and are Considered Gifts

Contributions to a qualified tuition program are made with after-tax funds. Thus, such contributions are not deductible by the taxpayer making the contribution for federal income tax purposes, regardless of whether the contribution is made to a prepaid tuition plan or education savings plan. Although no income tax deduction is available at the federal level, a taxpayer may be entitled to a tax deduction with respect to state income taxes if he or she is a resident of the state sponsoring the program.

Contributions to a qualified tuition program constitute non-charitable gifts and are treated as completed gifts of a present interest to the beneficiary. Such completed gifts of a present interest qualify for the gift tax annual exclusion. The gift tax annual exclusion amount for gifts made in 2025 is \$19,000. For married taxpayers, if one spouse gives more than the gift tax annual exclusion amount to a person during the year, the spouses can consent to treat the gift as made one-half by each spouse, this is called gift splitting. If both spouses consent to split the gift and all other gifts for the year, such contribution is considered a split gift resulting in a doubling of the gift tax annual exclusion amount or \$38,000 in 2025.

If a taxpayer makes contributions to a qualified tuition program in excess of the gift tax annual exclusion amount, the taxpayer may elect to take the contribution into account ratably over a 5-year period<sup>3</sup>. Qualified tuition program contributions exceeding the permitted annual exclusion are considered taxable gifts on which the taxpayer may incur a gift tax liability.

A contribution to a qualified tuition program (QTP), such as a 529 plan, is treated as a completed gift of a present interest to the designated beneficiary of the account. A special rule allows a donor to front-load a 529 plan for 5 years worth of the annual exclusion for a total of \$95,000 (\$190,000 for a married couple gift splitting) in 2025. This amount is excluded from gift tax if the donor elects to account for the gift ratably over a 5-year period. The election allows a taxpayer to apply the annual exclusion to a portion of the contribution in each of the 5 years, beginning in the year of contribution.

## Education Savings Program Earnings Tax Deferred

Contributions to an education savings program are generally made with the expectation that the fund will increase as a result of any earnings on the contributions. The amount of any earnings, of course, depends on the performance of the investment in which the contributions are placed. An important characteristic of such earnings when accrued in an education savings program is that they are tax-deferred. In other words, no income tax is payable during the period the fund is accumulating.

The benefit of tax deferral is potentially increased accumulation. The reason for the possible increase in the accumulation of a tax-deferred account when compared with an account that is currently taxable is that the funds that would have been used to pay the income tax liability in a currently-taxable account are permitted to remain in the tax-deferred account to produce additional gain. Not surprisingly, the benefits of tax-deferral increase substantially if the period of accumulation is extended.

We can see the benefits of tax deferral in the following chart that compares the accumulation of a tax-deferred account with a currently taxable account from which annual withdrawals are taken to pay the tax liability. For purposes of the illustration, it is assumed that a) the contributor makes annual \$10,000 contributions, b) is in a 25% tax bracket and c) the fund grows at an annual rate of 7%. Although a \$10,000 annual contribution has been assumed, contributions may be regular or irregular.

Year	Tax Deferred Accumulation	Currently Taxable Accumulation	Difference
1	\$10,700	\$10,525	\$175
2	22,149	21,603	546
3	34,399	33,262	1,138
4	47,507	45,533	1,974
5	61,533	58,448	3,084
6	76,540	72,042	4,498
7	92,598	86,349	6,249
8	109,780	101,407	8,372
9	128,164	117,256	10,908
10	147,836	133,937	13,899
11	168,885	151,494	17,390
12	191,406	169,972	21,434
13	215,505	189,421	26,084
14	241,290	209,891	31,400
15	268,881	231,435	37,446
16	298,402	254,110	44,292
17	329,990	277,976	52,014
18	363,790	303,095	60,695
19	399,955	329,532	70,423
20	438,652	357,358	81,294

As we can see from the above chart, the accumulation in the tax-deferred account is \$13,899 greater than in the currently-taxable account at the end of ten years provided the assumptions are met. At the end of 18 years—when a child for whom an education savings program began at birth would be likely to begin attending college—the balance in the tax-deferred account is \$60,695 greater than in the currently-taxable account.

Viewing the increased accumulation from a somewhat different perspective is instructive: the increased accumulation in the tax-deferred account at the end of 18 years based on our assumptions is equal to more than six years of contributions.

## Education Savings Plan Distributions may be Tax-Free

A distribution from an education savings plan is deemed to be comprised of a pro-rata share of the account's principal and accumulated tax-deferred earnings. To illustrate, suppose a taxpayer contributed \$40,000 to an education savings plan that currently has an accumulation of \$50,000, i.e. 20% of the account balance is comprised of earnings. If the taxpayer withdraws \$10,000 from the account, the withdrawal is comprised of \$8,000 of non-taxable contributions—contributions that are part of the taxpayer's non-deductible investment in the education savings plan—and \$2,000 of taxable earnings.

When a taxpayer receives a qualified tuition program distribution, he or she will receive an IRS Form 1099-Q. The amount of the gross distribution, shown in box 1 of the form, will be divided between the taxpayer's earnings (shown in box 2) and his or her investment, i.e. cost basis (shown in box 3).

To the extent a distribution from an education savings account is used to pay the designated beneficiary's qualified education expenses—adjusted to reflect any tax-free scholarships, grants, etc.—at an eligible educational institution, the entire distribution is income tax-free. To fully understand that statement, we need to define:

- Qualified education expenses; and
- Eligible educational institution.

### Qualified Education Expenses

Qualified education expenses are expenses related to enrollment or attendance at an eligible educational institution. (See Eligible Educational Institution below.) Such expenses include:

- Tuition and fees;
- Books, supplies, and equipment;
- Room and board expenses for students enrolled at least half-time only to the extent they are not more than the greater of (see Half-Time Student below):
  - The allowance for room and board included in the cost of attendance for federal financial aid purposes, or
  - The actual amount charged if the student resides in housing owned or operated by the eligible educational institution; and
- Expenses for special needs services required by a special needs beneficiary and incurred in connection with enrollment or attendance.

A "special needs student" is a student whose physical, mental, or emotional limitations require special accommodations to enable the student to successfully pursue higher education.

### **Half-Time Student**

A student is considered a "half-time student," for purposes of room and board expenses if enrolled for at least one-half the full-time academic workload for the course of study the student is pursuing. Such status, i.e. as a half-time student, must be determined under the standards of the educational institution at which the student is enrolled.

### **Adjustments to Qualified Education Expenses**

Distributions of earnings from a qualified tuition program are tax-exempt only to the extent the total distribution from the program does not exceed the beneficiary's qualified education expenses, adjusted for any tax-free educational assistance. Thus, for purposes of a distribution from an education savings plan, the total qualified education expenses must be reduced by any tax-free:

- Scholarships or fellowships;
- Veterans' educational assistance;
- Pell grants;
- Employer-provided educational assistance; and
- Other non-taxable payments, except gifts and inheritances, received as educational assistance.

Neither gifts nor inheritances are deducted from qualified education expenses to arrive at adjusted qualified education expenses.

### **Eligible Educational Institution**

An eligible educational institution at which the expenses specified above for enrollment or attendance would be considered qualified education expenses is defined fairly broadly. For purposes of a qualified tuition program, an eligible educational institution is any educational institution eligible to participate in a student aid program administered by the U.S. Department of Education and includes:

- College;
- University;
- Vocational school;
- Other post-secondary educational institutions; and
- Public, private, and religious elementary and secondary schools.

Thus, the definition of an eligible educational institution includes virtually all accredited U.S. public, nonprofit, and elementary, secondary, religious, and proprietary post-secondary institutions. In addition, certain educational

institutions located outside the United States also participate in the U.S. Department of Education's Federal Student Aid (FSA) programs and, as such, would generally be considered eligible educational institutions.

## Certain Education Savings Plan Distributions Taxable

Education savings plan distributions are tax-exempt to the extent they do not exceed the adjusted qualified education expenses of the beneficiary, adjusted to reflect certain types of tax-free educational assistance. However, the earnings included in any such distribution—if the distribution exceeds the beneficiary's adjusted qualified education expenses—are taxable.

Calculating the taxable portion of any education savings plan distribution that exceeds the beneficiary's adjusted qualified education expenses and which the taxpayer must include in income is fairly simple. It requires that:

1. The total distributed earnings (shown in box 2 of IRS Form 1099-Q) must be multiplied by a fraction the numerator of which (the number at the top of the fraction) is the adjusted qualified education expenses paid and the denominator of which (the number at the bottom of the fraction) is the total amount distributed to determine the tax-free portion of the distributed earnings; and
2. The amount determined in 1 above must be subtracted from the total distributed earnings shown in box 2 of Form 1099-Q.

For example, suppose a qualified tuition program beneficiary's qualified education expenses amount to \$25,000, and the student is awarded a partial tax-free tuition scholarship of \$7,000. Further, suppose that the student's parents received an education savings plan distribution of \$23,000 from a plan to which they made contributions over the years amounting to \$75,000 and whose current value is \$100,000. Based on the distribution, the taxpayer would receive Form 1099-Q partially reproduced below:

<input type="checkbox"/> CORRECTED (if checked)			
PAYER'S/TRUSTEE'S name, street address, city or town, state or province, country, ZIP or foreign postal code, and telephone no.		1 Gross distribution	OMB No. 1545-1760
		\$ <b>23,000</b>	Form <b>1099-Q</b>
		2 Earnings	(Rev. November 2019)
		\$ <b>5,750</b>	For calendar year 20 <u>    </u>
PAYER'S/TRUSTEE'S TIN	RECIPIENT'S TIN	3 Basis	4 Trustee-to-trustee transfer <input type="checkbox"/>
		\$ <b>17,250</b>	
RECIPIENT'S name		5 Distribution is from: • Qualified tuition program — Private <input type="checkbox"/> or State <input type="checkbox"/> • Coverdell ESA <input type="checkbox"/>	6 If this box is checked, the recipient is not the designated beneficiary <input type="checkbox"/>
Street address (including apt. no.)			
City or town, state or province, country, and ZIP or foreign postal code		If the fair market value (FMV) is shown below, see <b>Pub. 970, Tax Benefits for Education</b> , for how to figure earnings.	
Account number (see instructions)			

**Payments From Qualified Education Programs (Under Sections 529 and 530)**

**Copy B For Recipient**

This is important tax information and is being furnished to the IRS. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if this income is taxable and the IRS determines that it has not been reported.

Form **1099-Q** (Rev. 11-2019) (keep for your records) [www.irs.gov/Form1099Q](http://www.irs.gov/Form1099Q) Department of the Treasury - Internal Revenue Service

In our example, the beneficiary's \$25,000 of qualified college expenses were paid from the following sources:

Gift from parents	\$5,000
Partial tuition scholarship (tax-free)	\$7,000
QTP distribution	\$23,000

To determine the portion of the QTP distribution that must be included in income, the beneficiary's qualified education expenses must be adjusted. The adjustment requires that the qualified education expenses be reduced by any tax-free educational assistance. In this case, the beneficiary's qualified education expenses are \$25,000, and the tax-free educational assistance is \$7,000. Thus, the beneficiary's adjusted qualified education expenses are \$18,000, as shown below:

Total qualified education expenses	\$25,000
Partial tuition scholarship (tax-free)	<u>– 7,000</u>
Adjusted qualified education expenses	\$18,000

Since the adjusted qualified education expenses are less than the gross distribution, part of the distribution may be taxable.

Under step 1, we must multiply the earnings (box 2) by the applicable fraction. That calculation produces the amount of the distributed earnings that is tax-free. The calculation is as shown below:

$$\text{Earnings (box 2)} \times \frac{\text{Adjusted qualified education expenses}}{\text{Gross distribution (box 1)}} = \text{Tax-free portion of distributed earnings}$$

By substituting the applicable numbers in the equation, we can see that the tax-free portion of the earnings distributed as part of the education savings plan distribution is \$4,500:

$$\$5,750 \times \frac{\$18,000}{\$23,000} = \$4,500$$

Under step 2, we need to subtract the tax-free earnings result determined in step 1 (\$4,500 in this case) from the total distributed earnings of \$5,750. Thus, the portion of the distributed earnings that must be included in income is \$1,250 (\$5,750 - \$4,500). That amount is included on Form 1040 (Other Income). In many cases, a taxpayer who has a taxable distribution from an education savings plan will be liable for an additional tax equal to 10% of the amount included in his or her income. (See Additional Tax on Taxable Distributions below.)

Notice that the \$5,000 gift from the designated beneficiary's parents does not reduce the beneficiary's qualified education expenses for purposes of determining the portion of the excess distribution that must be included in income.

### **Coordination with American Opportunity and Lifetime Learning Credits**

An American opportunity or lifetime learning credit (see Chapter 4, Federal Tax Credits for Education) may be claimed in the same year the beneficiary receives a tax-free distribution from a qualified tuition program. However, the same education expenses cannot be used for both the qualified tuition program and the education credit.

Thus, an education savings plan distribution must be coordinated with these education credits. To accomplish that coordination, the beneficiary, after reducing qualified education expenses by any tax-free educational assistance, must also reduce his or her qualified education expenses by the expenses taken into account to determine the applicable education credit. As will be discussed more fully in Chapter 4, an American opportunity credit is a refundable tax credit equal to the sum of a) 100% of qualified tuition and related expenses up to \$2,000 and b) 25% of qualified tuition and related expenses exceeding \$2,000. The total American opportunity tax credit cannot exceed \$2,500.

Let's return to our earlier example but add the impact of taking a \$2,500 American opportunity credit. By taking the maximum American opportunity credit, the adjusted qualified education expenses for purposes of the qualified tuition plan are as follows:

Total qualified education expenses	\$25,000
Partial tuition scholarship (tax-free)	- 7,000
Expenses taken into account for American opportunity credit	<u>- 4,000</u>
Adjusted qualified education expenses	\$14,000

Because of the formula for determining the American opportunity credit, it requires that \$4,000 of college expenses be taken into account in order for the taxpayer to qualify for the maximum credit. By taking the American opportunity credit, the adjusted qualified education expenses are reduced. Thus, the beneficiary's adjusted qualified education expenses are \$14,000, as shown above. That reduction impacts the taxable distribution from the qualified tuition program. Thus, the revised calculation of the tax-free portion of the earnings distribution is as follows:

$$\$5,750 \times \frac{\$14,000}{\$23,000} = \$3,500$$

As we can see, the tax-free portion of the distribution of earnings from the education savings plan has been reduced from \$4,500 (before the American opportunity credit was taken) to \$3,500. Because the tax-free portion has been reduced, the taxable portion increases from \$1,250 (before the American opportunity credit was taken) to \$2,250 (\$5,750 - \$3,500). So, in this case, the taxpayer must include \$2,250 on Form 1040.

### Coordination with Coverdell Education Savings Account Distributions

A taxpayer may receive a distribution from a qualified tuition program in the same year he or she receives a distribution from a Coverdell education savings account. In such a case, if the total of the distributions is greater than the beneficiary's adjusted qualified higher education expenses, the expenses must be allocated between the qualified tuition program distribution and the Coverdell ESA distribution.

To illustrate how such coordination would work, let's assume that the beneficiary in our previous example took a \$23,000 total distribution. However, the distribution from the Coverdell ESA was \$2,000 and the distribution from the qualified tuition program was reduced to \$21,000. To determine how the adjusted qualified education expenses are allocated to each of the distributions, two equations are used.

To calculate the amount of adjusted qualified education expenses allocated to the Coverdell ESA, use the following equation:

$$\text{Adjusted qualified education expenses} \times \frac{\text{Coverdell ESA distribution}}{\text{Total distribution}} = \text{Adjusted qualified education expenses allocated to ESA distribution}$$

By substituting the appropriate values into the equation, we see that the adjusted qualified education expenses allocated to the Coverdell ESA distribution amount to \$1,217, as shown in the equation below:

$$\$14,000 \times \frac{\$2,000}{\$23,000} = \$1,217$$

Based on the portion of the adjusted qualified education expenses allocated to the Coverdell ESA distribution, the taxable portion of the Coverdell ESA distribution can be determined. (See Chapter 2.) Likewise, the adjusted qualified education expenses allocated to the qualified tuition program are determined in the same way. In this case, however, the equation is:

$$\text{Adjusted qualified education expenses} \times \frac{\text{QTP distribution}}{\text{Total distribution}} = \text{Adjusted qualified education expenses allocated to QTP distribution}$$

By again substituting the appropriate values into the equation, we calculate the portion of the adjusted qualified education expenses allocable to the qualified tuition program distribution to be \$12,783, as shown below:

$$\$14,000 \times \frac{\$21,000}{\$23,000} = \$12,783$$

## Additional Tax Payable on Taxable QTP Distributions

Not only must the taxable portion of any qualified tuition program distribution be recognized by the taxpayer, but he or she may be liable for an additional tax. The additional tax is equal to 10% of the amount of the qualified tuition program distribution included in income unless an exception applies. Thus, a taxpayer who must include \$1,000 in income as a taxable QTP distribution is liable for a \$100 additional tax in addition to the income tax liability on the \$1,000.

The additional tax is reported on the applicable line of Form 1040 or Form 1040-NR.

### Exceptions to Additional Tax Liability

The 10% additional tax does not apply to the taxable portion of a qualified tuition program distribution that must be included in income if:

- The distribution is paid to a beneficiary or designated beneficiary's estate on or after the death of the designated beneficiary;
- The designated beneficiary is disabled;
- It is included in income because the designated beneficiary received:
  - A tax-free scholarship or fellowship,
  - Veteran's educational assistance,
  - Employer-provided education assistance, or

- Any other non-taxable payments, other than gifts or inheritances, received as educational assistance;
- Made on account of the designated beneficiary's attendance at a U.S. military academy; or
- Included in income only because the qualified education expenses were taken into account in determining the American opportunity or lifetime learning credit.

## QTP Investment Losses

**NOTE:** For 2018 through 2025, a loss may not be claimed.

If a taxpayer incurs a loss on funds allocated to a qualified tuition program, the loss may be taken on his or her income tax return. In determining if a loss has occurred, the taxpayer must aggregate all their qualified tuition program accounts. Thus, a gain in one qualified tuition program would offset the loss in another qualified tuition program owned by the same taxpayer.

The loss, if any, may be taken only when all amounts from the account(s) have been distributed and the total distributions are less than the taxpayer's unrecovered basis. (The taxpayer's basis is equal to the total contributions made to the qualified tuition program.) The loss may be claimed as a miscellaneous itemized deduction on Schedule A (Form 1040), subject to the 2% of adjusted gross income limit.

The Tax Cuts and Jobs Act of 2017 (TCJA) temporarily suspends all miscellaneous itemized deductions that are subject to the 2-percent floor under present law. This provision is effective for taxable years beginning after December 31, 2017, and does not apply for taxable years beginning after December 31, 2025.

## Rollovers and QTP Beneficiary Changes

Qualified tuition program distributions that are rolled over to another qualified tuition program in accordance with the rollover rules are not taxable distributions. Under the rollover rules, no amount distributed from a qualified tuition program is taxable if it is rolled over to another qualified tuition program for the benefit of:

- The same beneficiary; or
- The beneficiary's family, including his or her spouse.

The rollover to the successor qualified tuition program must occur within 60 days after the date of the distribution. No tax reporting of any type is required for a distribution that is rolled over in accordance with the rules.

The beneficiary's family, for whose benefit a qualified tuition program distribution may be rolled over, is interpreted broadly. Accordingly, the beneficiary's family includes the beneficiary's spouse and the following relatives of the beneficiary:

- A son, daughter, stepchild, foster child, adopted child, or a descendant of any of them;
- A brother, sister, stepbrother, or stepsister;
- A father or mother or an ancestor of either;
- A stepfather or stepmother;
- A son or daughter of a brother or sister;
- A brother or sister of the beneficiary's father or mother;
- A son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law;
- The spouse of any individual listed above; or
- A first cousin.

There are no income tax consequences if the designated beneficiary of a qualified tuition program account is changed to a member of the beneficiary's family.

## Summary

Ensuring that obtaining an education is financially feasible is a very important financial objective for many taxpayers. Qualified Tuition Programs authorized under IRC §529 facilitate the attainment of that objective by encouraging individuals to save money they can use for education on a tax-exempt basis.

A qualified tuition program may be a prepaid tuition plan or an education savings plan. Although both types of qualified tuition programs offer a way to fund future education, they take varying approaches. Under a prepaid tuition plan, a taxpayer pays now for future education and is able to lock in the costs of attending college that may be many years in the future.

The advantages of prepaid tuition plans are that they provide a hedge against inflation, offer guarantees against the need to pay increased tuition, involve little or no risk, and normally outperform traditional savings approaches. The drawbacks of prepaid tuition plans are that participation may be available only to state residents, the amount contributed to the plan may be insufficient to cover the college costs if the beneficiary attends a private college or a college outside the state in which the plan is established, an education savings plan may offer an increased return over an extended time period, a prepaid tuition plan could impose a cancellation fee and/or a loss of interest in the event of withdrawal from the plan, and a prepaid tuition plan may adversely affect the amount of financial aid available to the beneficiary.

Under an education savings plan, a taxpayer invests money into a special account established for a designated beneficiary rather than purchasing future tuition credits. Earnings on the funds invested in an education savings plan are tax-deferred and may be entirely tax-free if used to pay qualified education expenses. The advantages of an

education savings plan include administrative simplicity, maintenance of taxpayer control, flexibility, and the avoidance of an adverse impact on financial aid. Additionally, recent expansions of the education savings plan provisions allow the funds to be spent on pre-college tuition at public, private, and religious elementary and secondary schools, apprenticeship programs registered with the Department of Labor, and student loan balances for both the beneficiary and their siblings (limitations apply). The drawbacks of an education savings plan include the taxpayer's shouldering the investment risk, the lack of a guarantee that the fund will be sufficient to pay future college costs, the adverse effect of imposed account fees, and the possibility of the lack of full disclosure.

No income qualification limits apply to qualified tuition program contributions. Although federal rules do not specify a dollar amount that may be contributed, the contributions to a qualified tuition program for a beneficiary cannot exceed the amount needed to pay the beneficiary's qualified education expenses. A taxpayer may contribute to both a qualified tuition program and to a Coverdell education savings account in the same year for the same beneficiary.

Contributions to a qualified tuition program are made with after-tax funds. Earnings on education savings program contributions are tax-deferred. To the extent a distribution from an education savings account is used to pay the designated beneficiary's qualified education expenses—adjusted to reflect any tax-free scholarships, grants, etc.—at an eligible educational institution, the entire distribution is income tax-free.

Qualified education expenses are expenses related to enrollment or attendance at an eligible educational institution and include tuition and fees, books, supplies and equipment, room and board expenses for students enrolled at least half-time not exceeding certain limits, and the expenses of certain services required by special needs students. Virtually all accredited U.S. public, nonprofit, and proprietary post-secondary institutions meet the definition of an eligible education institution. Recent legislative changes include all public, as well as private and religious elementary and secondary institutions.

For tax purposes, the total qualified education expenses are reduced by any tax-free scholarships, fellowships, tuition reductions, veterans' educational assistance, Pell grants, employer-provided educational assistance, and certain other non-taxable payments received as educational assistance.

The earnings included in a distribution from an education savings plan are taxable if the distribution exceeds the beneficiary's adjusted qualified education expenses. An American opportunity or lifetime learning credit may also be claimed in the same year the beneficiary receives a tax-free distribution from a qualified tuition program. However, the education savings plan distribution must be coordinated with these education credits.

In addition, a taxpayer may receive a distribution from a qualified tuition program in the same year he or she receives a distribution from a Coverdell education savings account. In such a case, any excess distribution must be allocated between the qualified tuition program distribution and the Coverdell ESA distribution for tax purposes.

Not only must the taxable portion of any qualified tuition program excess distribution be recognized by the taxpayer, but they may also be liable for an additional tax as a result of the excess distribution. The additional tax is equal to 10% of the amount of the qualified tuition program distribution included in income unless an exception applies. Exceptions to the additional tax apply in the case of a) the designated beneficiary's death or disability, b) the receipt of a scholarship, fellowship, or other non-taxable education assistance, c) the beneficiary's attendance at a U.S. military academy, or d) excess distributions included in income only because the expenses were taken into account in determining the American opportunity or lifetime learning credit.

Contributions to an education savings plan may be invested in a portfolio that loses money. If a taxpayer incurs a loss on funds allocated to a qualified tuition program, the loss may be taken on his or her income tax return. **NOTE: For 2018 through 2025, a loss may not be claimed.** In determining if a loss has occurred, the taxpayer must aggregate all his or her qualified tuition program accounts and offset any losses in one qualified tuition program by any gain in another qualified tuition program. After offsetting any losses by any gains, the loss may be claimed as a miscellaneous itemized deduction on Schedule A (Form 1040), subject to the 2% of adjusted gross income limit.

The Tax Cuts and Jobs Act of 2017 (TCJA) temporarily suspends all miscellaneous itemized deductions that are subject to the 2-percent floor under present law. This provision is effective for taxable years beginning after December 31, 2017, and does not apply for taxable years beginning after December 31, 2025.

Qualified tuition program funds may be rolled over to avoid a taxable distribution. Qualified tuition program distributions that are rolled over to another qualified tuition program in accordance with the rollover rules are not taxable distributions. Under the rollover rules, no amount distributed from a qualified tuition program is taxable if it is rolled over to another qualified tuition program for the benefit of the same beneficiary or the beneficiary's family, including his or her spouse. In such a case the rollover must occur within 60 days following the date of the distribution. No tax reporting of any type is required for a distribution that is rolled over in accordance with the rules. Furthermore, there are no income tax consequences if the designated beneficiary of a qualified tuition program account is changed to a member of the beneficiary's family.

## CHAPTER 2 - COVERDELL EDUCATION SAVINGS ACCOUNTS

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### Introduction

Coverdell education savings accounts permit an eligible taxpayer to save money to pay future qualified education expenses for a designated beneficiary. Except for a special needs beneficiary, a designated ESA beneficiary must be younger than age 18 at the time of the contribution.

Contributions to an ESA are not tax-deductible, but any gain on the account is tax-deferred. Distributions from an ESA to pay qualified education expenses are tax-exempt.

### Chapter Learning Objectives

In this chapter, we will look at the rules governing Coverdell Education Savings Accounts (ESAs). When you have completed this chapter you should be able to:

- Apply the federal income tax rules to ESA contributions, earnings, and distributions;
- Recognize the eligibility requirements applicable to ESA contributors and beneficiaries;
- Identify the ESA contribution limits; and
- Apply the rules governing ESA rollovers.

### Definition and Eligibility

A Coverdell education savings account (ESA) is a federal program providing tax incentives and created to encourage taxpayers to save money to pay education expenses. Originally called an Education IRA, an ESA is defined as a trust or custodial account designed to enable taxpayers to save education funds on a tax-deferred basis and make tax-free withdrawals to pay for qualified education expenses. In 2002 and later, the total amount that may be contributed to an ESA each year for a designated beneficiary—exclusive of any rolled-over amount—is \$2,000 regardless of the number of ESAs established for the beneficiary. A taxpayer may establish ESAs for multiple designated beneficiaries.

Like many tax-advantaged programs authorized under federal law, certain income eligibility requirements apply in the case of an ESA. Thus, the maximum modified adjusted gross income (MAGI) that a single tax filer can have and still take full advantage of the ESA is \$95,000. For joint tax filers, the maximum MAGI is \$190,000. Eligibility to make an ESA contribution is phased out for MAGIs in excess of those amounts and is lost at a MAGI of \$110,000 for single filers and \$220,000 for joint filers.

For ESA purposes, "modified adjusted gross income" is the taxpayer's adjusted gross income increased by income derived from certain foreign sources or sources within United States possessions that is otherwise excluded<sup>4</sup>. So, the modified adjusted gross income referred to with respect to Coverdell ESAs is adjusted gross income plus any excluded income from these two sources.

## Limits on Contributions

A joint tax filer with a modified adjusted gross income of \$190,000 or less can make a maximum ESA contribution. The formula for calculating the reduction from the maximum ESA contribution for a high-income joint tax filer is as follows:

$$\text{Reduction in Contribution (Joint)} = \frac{\text{MAGI} - \$190,000}{\$30,000} \times \text{Maximum Permitted Contribution}$$

So, if an individual has a modified AGI of \$205,000, for example, the maximum contribution that he or she could make to a Coverdell ESA is \$1,000. We can see how the formula works to reduce the maximum ESA contribution by substituting the appropriate numbers into the equation:

$$\text{Reduction in Contribution (Joint)} = \frac{\$205,000 - \$190,000}{\$30,000} \times \$2,000$$

For the individual's modified adjusted gross income, we substitute \$205,000; this gives us a fraction of \$15,000 ÷ \$30,000, or 1/2. Multiplied by \$2,000, we have a reduction in the permitted contribution equal to \$1,000. Since the maximum contribution is normally \$2,000, this high-income individual would be limited to making an ESA contribution of no more than \$1,000. As you can see from the formula, a joint filer doesn't completely lose the contribution unless their modified adjusted gross income exceeds \$220,000.

The same kind of calculation needs to be done for the high-income individual tax filer. A single tax filer with a modified adjusted gross income of \$95,000 or less can make a maximum ESA contribution. Just as the maximum contribution was phased out for the joint tax filer client, it is also phased out for the individual filer client. In the case of an individual tax filer, however, the phase-out is over a \$15,000 range, rather than the \$30,000 range that applies in the case of joint tax filers.

So, the formula for determining the reduction in the maximum permitted ESA contribution for a high-income individual tax filer is as follows:

$$\text{Reduction in Contribution (Indiv)} = \frac{\text{MAGI} - \$95,000}{\$15,000} \times \text{Maximum Permitted Contribution}$$

As you can see from the formula, the individual filer doesn't completely lose the contribution unless his or her modified adjusted gross income exceeds \$110,000. By making the same calculations that we made for the joint filer, we can calculate the high-income individual filer's reduced maximum contribution.

Contributions to Coverdell ESAs can be invested in savings accounts, individual stocks, bonds, CDs, or mutual funds. Such contributions cannot be allocated to a life insurance contract.

If a taxpayer's modified adjusted gross income is \$110,000 or more (\$220,000 or more if filing a joint return), the taxpayer cannot contribute to anyone's Coverdell ESA.

## Eligible ESA Beneficiaries

Assuming that an individual is eligible to make a full ESA contribution, he or she may contribute \$2,000 each tax year on behalf of each beneficiary. A beneficiary may be any individual who is age 18 or less. However, if the beneficiary is a special needs beneficiary, the "age 18 or less" requirement does not apply. Although a final definition of a special needs beneficiary has not yet been provided, a special needs beneficiary is expected to include individuals who require additional time to complete their education because of physical, mental or emotional conditions.

The legislation that authorized ESAs does not require any relationship between the ESA donor and the beneficiary. So, an individual may make a \$2,000 contribution for his or her child, grandchild or someone who is not related at all. In addition, a donor may establish multiple ESAs for many children, grandchildren or friends provided the annual contribution to each does not exceed \$2,000 and the beneficiary, unless it is a special needs beneficiary, is not older than 18.

The contribution to a Coverdell ESA must be made to a trust or custodial account which may allocate the funds to a wide range of investments. However, the legislation specifically prohibits the purchase of life insurance with the assets of the ESA.

## Tax Considerations

Let's turn our attention to the tax aspects of the ESA. Contributions made to an ESA are not tax-deductible; they are made with after-tax dollars. Contributions made to an ESA that are in excess of the amount that the individual is eligible to make, based on his or her MAGI, are subject to a penalty. Although ESA contributions are not tax-deductible, the donor may incur a 6% excise tax for donations that exceed the maximum allowable. The excise tax will be levied each year for as long as the excess contribution remains in the account.

Since contributions are not tax-deductible and may incur an excise tax, the attraction of an ESA lies in its:

- Tax deferral of accumulations; and
- Possible tax-free distributions.

Although there are no tax benefits given to contributions to an ESA, there are definite benefits that apply to their accumulation and distribution. Specifically, taxes are deferred on accumulations in the ESA, and distributions may be tax-free.

## Tax-Free ESA Distributions

In order for distributions from an ESA to be excludable from income for tax purposes, the distribution received during the year must be used solely for the qualified education expenses of the designated beneficiary. Qualified education expenses are reduced by the amount of any such expenses taken into account in determining the American Opportunity Credit or the Lifetime Learning Credit.

There are two important limitations pertaining to ESA distributions. The first limitation on the distribution is that it must be used solely for qualified education expenses, and the second is that the distribution must be used for the designated beneficiary. If a distribution is taken from an ESA and fails to meet either of these requirements, the distribution would be subject to income tax using the exclusion ratio for the investment in the contract.

### Qualified Education Expenses

Let's turn our attention now to the meaning of "qualified education expenses" for ESA purposes. The expenses that are considered qualified education expenses for purposes of a Coverdell ESA are as shown below:

Higher Education Expenses Including:	Elementary and Secondary Education Expenses Including:
Tuition	Tuition and fees
Fees	Academic tutoring
Books	Special needs services
Supplies	Books, supplies & other needed equipment
Equipment	Uniforms & transportation
Room and board	Other supplementary items & services

In addition, qualified education expenses include amounts contributed to a qualified tuition program.

The term "qualified education expenses" covers most of the expenses that a student is likely to encounter, including tuition, fees, books, supplies, and, as long as the student is enrolled at least half-time, room and board.

### Eligible Educational Institution

According to the ESA rules, qualified education expenses must be incurred in an eligible educational institution. An "eligible educational institution" may be either an eligible elementary or secondary school, or it may be a postsecondary school. Thus, an eligible education institution, for purposes of a Coverdell ESA, is any:

- College;
- Vocational school;

- University; or
- Other elementary, secondary, or post-secondary institutions.

The definition of "eligible educational institution" is remarkably broad and covers virtually all accredited public, nonprofit, and proprietary educational institutions.

## Taxation of Excess ESA Distributions

Distributions from an ESA may be includible in the recipient's income if they are not used solely for qualified education expenses for a designated beneficiary. Thus, a distribution would be includible in income if the distribution includes earnings and exceeds the designated beneficiary's adjusted qualified education expenses for the year.

When a taxpayer receives a distribution from a Coverdell ESA, he or she will receive a Form 1099-Q. As in the case of a §529 qualified tuition program distribution, the amount of the gross distribution will be shown in box 1, earnings in box 2, and basis in box 3. Thus, the taxpayer will receive a Form 1099-Q as shown in the partial reproduction below:

<input type="checkbox"/> CORRECTED (if checked)		OMB No. 1545-1760 Form <b>1099-Q</b> (Rev. November 2019) For calendar year 20__		<b>Payments From Qualified Education Programs (Under Sections 529 and 530)</b>
PAYER'S/TRUSTEE'S name, street address, city or town, state or province, country, ZIP or foreign postal code, and telephone no.		<b>1</b> Gross distribution \$ <b>XX,XXX.XX</b>	<b>2</b> Earnings \$ <b>XX,XXX.XX</b>	
PAYER'S/TRUSTEE'S TIN	RECIPIENT'S TIN	<b>3</b> Basis \$ <b>XX,XXX.XX</b>	<b>4</b> Trustee-to-trustee transfer <input type="checkbox"/>	
RECIPIENT'S name		<b>5</b> Distribution is from: • Qualified tuition program— Private <input type="checkbox"/> or State <input type="checkbox"/> • Coverdell ESA <input type="checkbox"/>		
Street address (including apt. no.)		If the fair market value (FMV) is shown below, see <b>Pub. 970, Tax Benefits for Education</b> , for how to figure earnings.		
City or town, state or province, country, and ZIP or foreign postal code				
Account number (see instructions)				

Form **1099-Q** (Rev. 11-2019) (keep for your records) [www.irs.gov/Form1099Q](http://www.irs.gov/Form1099Q) Department of the Treasury - Internal Revenue Service

Calculating the taxable portion of any ESA distribution that exceeds the beneficiary's adjusted qualified education expenses and which the taxpayer must include in income is fairly simple. It requires that:

1. The total distributed earnings must be multiplied by a fraction the numerator of which is the adjusted qualified education expenses paid and the denominator of which is the total amount distributed to determine the tax-free portion of the distributed earnings; and
2. The amount determined in 1 above must be subtracted from the total distributed earnings.

For example, suppose a qualified tuition program beneficiary's qualified education expenses amount to \$34,000 and an American opportunity credit that accounts for \$4,000 is taken. Further, suppose that the ESA distribution was \$40,000. Based on the distribution, the taxpayer would receive the Form 1099-Q partially reproduced below:

<input type="checkbox"/> CORRECTED (if checked)		OMB No. 1545-1760 <b>Form 1099-Q</b> (Rev. November 2019) For calendar year 20__		<b>Payments From Qualified Education Programs (Under Sections 529 and 530)</b>	
PAYER'S/TRUSTEE'S name, street address, city or town, state or province, country, ZIP or foreign postal code, and telephone no.		1 Gross distribution <b>\$ 40,000.00</b>	2 Earnings <b>\$ 4,000.00</b>		
		PAYER'S/TRUSTEE'S TIN	RECIPIENT'S TIN	3 Basis <b>\$ 36,000.00</b>	4 Trustee-to-trustee transfer <input type="checkbox"/>
RECIPIENT'S name		5 Distribution is from: • Qualified tuition program— Private <input type="checkbox"/> or State <input type="checkbox"/> • Coverdell ESA <input type="checkbox"/>		6 If this box is checked, the recipient is not the designated beneficiary <input type="checkbox"/>	
Street address (including apt. no.)		If the fair market value (FMV) is shown below, see <b>Pub. 970, Tax Benefits for Education</b> , for how to figure earnings.			
City or town, state or province, country, and ZIP or foreign postal code		Account number (see instructions)			

Form **1099-Q** (Rev. 11-2019) (keep for your records) [www.irs.gov/Form1099Q](http://www.irs.gov/Form1099Q) Department of the Treasury - Internal Revenue Service

### Calculating Earnings Distributed

Alternatively, an ESA payer may provide a Form 1099-Q that only shows the gross distribution in box 1 but no amounts in boxes 2 or 3. If the Form 1099-Q shows only the gross distribution, the amount of the distribution that would be included in box 2 as earnings is calculated as follows:

1. The total amount distributed (box 1) is multiplied by a fraction. The numerator of the fraction is the taxpayer's basis at the end of the previous year, and the denominator of the fraction is the balance in the ESA at the end of the current year plus the amount distributed during the current year. The result is the taxpayer's basis that is included in the distribution which would normally be shown in box 3.
2. Subtract the amount determined in step 1 (above) from the gross distribution. The result is the amount of earnings in the distribution which would normally be shown in box 2.

To calculate the portion of the gross distribution that constitutes basis, we would use the following equation:

$$\text{Gross Distribution} \times \frac{\text{Taxpayer's Basis end of prior year}}{\text{ESA value end of dist. yr.} + \text{amt dist. current yr}} = \text{Distributed Basis}$$

For example, suppose that a taxpayer received a \$20,000 ESA distribution during the year. Further, suppose that the taxpayer's contributions at the end of the previous year that were not previously distributed amounted to \$150,000 and the balance in the ESA at the end of the year in which the distribution was received was \$180,000. We can determine that the portion of the \$20,000 gross distribution that constitutes basis is \$15,000 by substituting the appropriate values as follows:

$$\$20,000 \times \frac{\$150,000}{(\$180,000 + \$20,000)} = \$15,000$$

The balance of the gross distribution, i.e. \$5,000, is the portion of the distribution comprised of earnings on the ESA. Thus, in this case, Form 1099-Q box 1 would have been \$20,000, box 2 would have been \$5,000 and box 3 would have been \$15,000.

### Adjusted Qualified Education Expenses

To determine if the total distributions from an ESA for the year are greater than the amount of qualified education expenses, the total qualified education expenses must be reduced by any tax-free education assistance. As previously noted, in connection with qualified tuition programs, tax-free education assistance includes:

- The tax-free portion of scholarships and fellowships;
- Veterans' educational assistance;
- Pell grants;
- Employer-provided educational assistance; and
- Other non-taxable payments, except gifts and inheritances, received as educational assistance.

### Coordination with American Opportunity and Lifetime Learning Credits

An American opportunity or lifetime learning credit (see Chapter 4 Federal Tax Credits for Education) may be claimed in the same year the beneficiary receives a tax-free distribution from an ESA. However, just as in the case of a QTP, the same education expenses cannot be used for both the ESA and the education credit.

Thus, an ESA distribution must be coordinated with these education credits. To accomplish that coordination, the beneficiary, after reducing qualified education expenses by any tax-free educational assistance, must also reduce his or her qualified education expenses by the expenses taken into account to determine the applicable education credit. As will be discussed more fully in Chapter 4, an American opportunity credit is a refundable tax credit equal to the sum of a) 100% of qualified tuition and related expenses up to \$2,000 and b) 25% of qualified tuition and related expenses exceeding \$2,000. The total American opportunity tax credit cannot exceed \$2,500. Thus, in order to take a full \$2,500 American opportunity credit, the taxpayer must take \$4,000 of qualified higher education expenses into account.

### Coordination with Qualified Tuition Program Distributions

A taxpayer may receive a distribution from a Coverdell ESA in the same year he or she receives a distribution from a qualified tuition program. In such a case, if the total of the distributions is greater than the beneficiary's adjusted qualified higher education expenses, the expenses must be allocated between the two distributions.

To calculate the amount of adjusted qualified education expenses allocated to the Coverdell ESA, use the following equation:

$$\text{Adjusted qualified education expenses} \times \frac{\text{Coverdell ESA distribution}}{\text{Total QTP \& ESA distribution}} = \frac{\text{Adjusted qualified education expenses}}{\text{allocated to ESA distribution}}$$

So, if the total adjusted qualified education expenses were \$20,000, the ESA distribution was \$5,000 and the total QTP & ESA distribution was \$25,000, we can see that the adjusted qualified education expenses allocated to the ESA distribution amount to \$4,000, as shown in the equation below:

$$\$20,000 \times \frac{\$5,000}{\$25,000} = \$4,000$$

Based on the portion of the adjusted qualified education expenses allocated to the Coverdell ESA distribution, the taxable portion of the ESA distribution can be determined.

## Additional Tax Payable on Taxable ESA Distributions

Not only must the taxable portion of an ESA distribution be recognized by the taxpayer, he or she may also be liable for an additional tax. The additional tax is equal to 10% of the amount of the ESA distribution included in income unless an exception applies. Thus, a taxpayer who must include \$1,000 in income as a taxable ESA distribution is liable for a \$100 additional tax in addition to the income tax liability on the \$1,000.

The additional tax is reported on the applicable line of Form 1040 or Form 1040-NR.

### Exceptions to Additional Tax Liability

The 10% additional tax does not apply to the taxable portion of an ESA distribution that must be included in income if:

- The distribution is paid to a beneficiary or designated beneficiary's estate on or after the death of the designated beneficiary;
- The designated beneficiary is disabled;
- It is included in income because the designated beneficiary received:
  - A tax-free scholarship or fellowship,
  - Veteran's educational assistance,
  - Employer-provided education assistance, or
  - Any other non-taxable payments, other than gifts or inheritances, received as educational assistance;
- Made on account of the designated beneficiary's attendance at a U.S. military academy; or
- Included in income only because the qualified education expenses were taken into account in determining the American opportunity or lifetime learning credit.

## Coverdell ESA Investment Losses

**NOTE:** For 2018 through 2025, a loss may not be claimed.

If a taxpayer incurs a loss on the investment in a Coverdell ESA, the loss may be deducted on his or her income tax return. In determining if a loss has occurred, the taxpayer must combine the information (amount of distribution, basis, etc.) from all such accounts. Accordingly, a loss from one ESA reduces the distributed earnings from any other ESA.

The loss, if any, may be taken only when all amounts from the account(s) have been distributed and the total distributions are less than the taxpayer's unrecovered basis. (The taxpayer's basis is equal to the total contributions made to the ESA.) The loss may be claimed as a miscellaneous itemized deduction on Schedule A (Form 1040), subject to the 2% of adjusted gross income limit.

The Tax Cuts and Jobs Act of 2017 (TCJA) temporarily suspends all miscellaneous itemized deductions that are subject to the 2-percent floor under present law. This provision is effective for taxable years beginning after December 31, 2017, and does not apply for taxable years beginning after December 31, 2025.

### Calculating the Taxable Part of the Distribution

Although any distribution from an ESA on which there is a gain would be comprised partly of gain, some or all of the gain is tax-exempt depending on whether or not the ESA distribution is an excess distribution. An excess distribution is an ESA distribution that exceeds the adjusted qualified education expenses. If the distribution is not an excess distribution, no part of the distribution is taxable.

The amount of the total distributed earnings shown in box 2 of Form 1099-Q (or calculated as discussed in the prior section) that must be included in income is determined as follows:

1. The total distributed earnings must be multiplied by a fraction. The numerator of the fraction is the adjusted qualified education expenses paid and the denominator is the total amount distributed. The result is the tax-free portion of the distributed earnings; and
2. The amount determined in 1 above must be subtracted from the total distributed earnings shown in box 2 of Form 1099-Q (or as calculated).

The equation for determining the tax-free portion of the distributed earnings is as follows:

$$\text{Distributed Earnings} \times \frac{\text{Adjusted Qualified Education Expenses}}{\text{ESA Distribution}} = \text{Tax-free portion of distributed ESA earnings}$$

Returning to the previous example in which we determined that \$5,000 of the \$20,000 ESA distribution was comprised of earnings, let's assume that the adjusted qualified education expenses were \$18,000.

By substituting the applicable numbers in the equation, we can see that the tax-free portion of the earnings distributed as part of the college savings plan distribution is \$4,500.

$$\$5,000 \times \frac{\$18,000}{\$20,000} = \$4,500$$

By subtracting the tax-free portion of the distributed earnings from the total distributed earnings, we calculate the part of the excess distribution includible in income to be \$500 (\$5,000 - \$4,500). The taxable amount must be reported on the applicable line of Form 1040 or Form 1040-NR.

## ESA Rollovers

Sometimes, a designated beneficiary will choose not to attend school even though an ESA has been established for him or her. As a result, there may be funds in an ESA for the designated beneficiary at the time he or she attains age 30, the date at which the funds in the ESA must generally be used.

Except in the case of a special needs beneficiary, the funds that remain in an ESA must be distributed within 30 days of the beneficiary reaching age 30. Any amount that remains at the end of that 30-day period will be deemed to be distributed unless it is rolled over.

Funds in an ESA may be rolled over to another ESA provided the designated beneficiary of the recipient ESA is a member of the family of the original designated beneficiary and has not yet reached age 30. The age requirement for a rollover beneficiary is disregarded in the case of a special needs beneficiary. The rollover to the recipient ESA must be made no later than 60 days after the date of distribution from the original ESA. And, only one rollover is allowed during any 12-month period.

The ESA beneficiary's family is defined in the same way as members of the beneficiary's family were defined for qualified tuition programs. Thus, the term "family members" includes the beneficiary's spouse and the following relatives of the beneficiary:

- A son, daughter, stepchild, foster child, adopted child, or a descendant of any of them;
- A brother, sister, stepbrother, or stepsister;
- A father or mother or an ancestor of either;
- A stepfather or stepmother;
- A son or daughter of a brother or sister;
- A brother or sister of the beneficiary's father or mother;
- The son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law;

- The spouse of any individual listed above; or
- A first cousin.

There are no income tax consequences if the designated beneficiary of an ESA is changed to a member of the beneficiary's family.

## Summary

Coverdell education savings accounts are trust or custodial accounts created exclusively for the purpose of paying the qualified education expenses of the trust beneficiary. In order to encourage savings for education, these ESAs offer tax deferral of account growth and possible tax-free distribution when used to pay qualified education expenses. ESA contributions, however, are not tax-deductible.

ESA contributions may be made for a designated beneficiary age 18 or younger or for a special needs beneficiary at any age. Although the maximum annual contribution is \$2,000, eligibility to make contributions is phased out at higher contributor income levels. ESA funds must generally be used for qualified education expenses by the time the designated beneficiary attains age 30.

Except in those cases in which the designated beneficiary is a special needs beneficiary, any ESA funds not used by age 30 must be distributed within 30 days of the designated beneficiary's reaching age 30. ESA funds may be rolled over to another ESA for the same beneficiary or for another beneficiary who is a member of the former beneficiary's family. (See Appendix B for a comparison of the principal features of a Coverdell ESA with a qualified tuition program.)



## CHAPTER 3 - EDUCATION SAVINGS BOND PROGRAM

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### Introduction

Eligible taxpayers may exclude the interest on certain U.S. savings bonds when they incur qualified education expenses at an eligible educational institution. Qualified education expenses - limited to tuition, fees and contributions to specified federal programs designed to facilitate payment of a beneficiary's education expenses-re reduced by tax-free education benefits received during the year. Taxpayers' eligibility to exclude interest under the education savings bond program is limited to those taxpayers whose modified adjusted gross income does not exceed specified levels that vary based on filing status.

### Chapter Learning Objectives

In this chapter, we will look at the federal education savings bond program rules. When you have completed this chapter you should be able to:

- Identify the U.S. savings bonds included in the education savings bond program;
- List the education expenses that qualify under the education savings bond program;
- Recognize the kind of educational institutions that are eligible for inclusion in the education savings bond program;
- Identify the benefits whose receipt reduces a taxpayer's qualified education expenses; and
- Calculate the tax-free portion of adjusted qualified education expenses.

### Education Savings Bond Program in Brief

Although the interest on U.S. savings bonds is normally taxable as ordinary income, a taxpayer may exclude some or all of the interest on certain cashed in savings bonds if he or she pays qualified education expenses and meets federal income tax filing status and income requirements. Under the federal education savings bond program a taxpayer may exclude interest income on qualified U.S. savings bonds if the taxpayer:

- Paid qualified education expenses for the taxpayer, a spouse, or a dependent claimed by the taxpayer;
- Has a modified adjusted gross income (MAGI) not exceeding specified maximum amounts; and
- Has a federal income tax filing status other than married filing separately.

### Qualified U.S. Savings Bonds

The U.S. savings bonds that qualify for the education savings program are series EE bonds issued after 1989 and series I bonds. The bonds must be issued either in the taxpayer's name as sole owner or in the name of the taxpayer and spouse as co-owners. Furthermore, in order for the bond to qualify, the owning taxpayer must have been at least age 24 before the bond's date of issue.

## Qualified Education Expenses

Education expenses that qualify for the education savings bond program are those otherwise qualified education expenses incurred at an eligible educational institution by the taxpayer for the taxpayer, the taxpayer's spouse, or a dependent claimed by the taxpayer. Such expenses include:

- Tuition and fees;
- Contributions to a qualified tuition program; and
- Contributions to a Coverdell education savings account (ESA).

Room and board expenses are not qualified education expenses for purposes of the education savings bond program.

## Eligible Educational Institutions

Similar to the educational institutions eligible under a qualified tuition program, an eligible educational institution for purposes of the education savings bond program is broadly defined. An eligible educational institution is one eligible to participate in a student aid program administered by the U.S. Department of Education and includes:

- College;
- University;
- Vocational school; and
- Other post-secondary educational institution.

Thus, the definition of an eligible educational institution includes virtually all accredited U.S. public, nonprofit, and proprietary post-secondary institutions.

## Qualified Education Expenses Reduced by Certain Tax-free Benefits Received

The qualified education expenses incurred must be reduced, for purposes of the education savings bond program, by certain tax-free education benefits received. The resulting education expenses, reduced as required, are referred to as "adjusted qualified education expenses".

Thus, adjusted qualified education expenses are equal to the qualified education expenses reduced by all of the following tax-free benefits:

- The tax-free part of scholarships and fellowships;
- Expenses used to figure the tax-free portion of Coverdell ESA distributions;
- Expenses used to figure the tax-free portion of qualified tuition program distributions;

- Any tax-free payments received as education assistance, including:
  - Veterans' educational assistance benefits,
  - Qualified tuition reductions, and
  - Employer-provided educational assistance; and
- Any expenses used in figuring the American opportunity and lifetime learning credits.

Neither gifts nor inheritances received, however, reduce qualified education expenses for purposes of the education savings bond program.

## Figuring the Potentially Tax-Free Amount

If the total amount, including both the bond investment and accrued interest, received by the taxpayer when eligible bonds are cashed in does not exceed the adjusted qualified education expenses, all interest received may be tax-free. (Note: The taxpayer must still be eligible based on income.) If the total amount received is greater than the adjusted qualified education expenses, only a portion of the interest may be tax-free.

Determining the tax-free amount of the interest distributed when the bonds are cashed in and the adjusted qualified education expenses are less than the distribution requires that the interest received be multiplied by a fraction. The numerator of the fraction is the adjusted qualified education expenses, and the denominator of the fraction is the total proceeds received during the year when the bonds were cashed in.

We can illustrate the part of the interest that is tax-free by considering an example. Suppose a taxpayer received a \$9,000 distribution of bond proceeds during the year, and the proceeds consisted of \$6,000 of invested principal and \$3,000 of interest. Further, suppose that the adjusted qualified education expenses were \$7,650. To determine the part of the \$3,000 of interest that may be tax-free, we need to use the following equation:

$$\text{Interest} \times \frac{\text{Adjusted qualified education expenses}}{\text{Total proceeds received}} = \text{maximum tax-free interest}$$

By substituting the appropriate numbers into the equation, we can see that the amount of the tax-free interest in this example is \$2,550, as shown below:

$$\$3,000 \times \frac{\$7,650}{\$9,000} = \$2,550$$

Since the taxpayer received \$9,000 when cashing in the bonds, the \$6,000 of investment is tax-free as a recovery of their cost basis, but the portion of the interest other than the tax-free amount—\$450 in this case—is taxable interest. As noted earlier, however, a taxpayer's eligibility for the education savings bond program is determined by the taxpayer's income and filing status, discussed immediately below. Depending on the taxpayer's MAGI and filing status, some or all of the maximum tax-free interest may also be includible in income.

## Education Savings Bond Program Eligibility Subject to Income Limits Based on Filing Status

Eligibility to exclude savings bond interest reduces as income increases and is eliminated at certain higher income levels. Under the bond program rules, the amount of a taxpayer's interest exclusion is gradually reduced if the taxpayer's modified adjusted gross income (MAGI) exceeds the applicable amount for the taxpayer's filing status.

For most taxpayers, modified adjusted gross income (MAGI), is the taxpayer's adjusted gross income (AGI) without taking the interest exclusion into account. However, in some cases determining a taxpayer's MAGI requires additional modifications.

When the taxpayer files Form 1040, the taxpayer's MAGI is their AGI without taking the savings bond interest exclusion into account, and is further modified by adding back any of the following:

- Foreign earned income exclusion;
- Student loan interest deduction;
- Foreign housing deduction;
- American Samoa residents' income exclusion;
- Puerto Rico residents' income exclusion;
- Foreign housing exclusion; and
- Excluded employer adoption assistance benefits.

When the part of the bond interest that would be tax-free under the education savings bond program is determined, the taxpayer's MAGI is compared to the applicable amount to calculate the amount of the tax-free interest that is excludible by the taxpayer. If a taxpayer whose filing status is married filing jointly has a MAGI that exceeds the applicable amount by \$30,000 or more, no interest may be excluded under the program. Similarly, if a taxpayer whose filing status is single, head of household, or qualifying surviving spouse has a MAGI that exceeds the applicable amount by \$15,000 or more, no interest may be excluded under the program. However, if a taxpayer's filing status is married filing separately, no interest is excludible under the education savings bond program, a married filing separately taxpayer does not qualify for this exclusion.

The amount of a taxpayer's tax-free interest under the education savings bond program is gradually reduced or eliminated based on the taxpayer's filing status and MAGI. These phase-out levels are indexed for inflation. Accordingly, the 2025 applicable amounts under the education savings bond program, for purposes of tax-free interest, are:

Taxpayer's Filing Status	Applicable Amount	Completely Phased-out
Single (S), Head of Household (HH), Qualifying Surviving Spouse (QSS)	\$99,500	\$114,500
Married Filing Jointly (MFJ)	\$149,250	\$179,250
<b>NOTE:</b> If the taxpayer's filing status is married filing separately (MFS), the taxpayer does not qualify for this exclusion.		

The amount of excludible savings bond interest to which a taxpayer whose MAGI exceeds the applicable amount is entitled, if any, can be determined using the following equation:

$$\frac{\text{MAGI} - \text{Applicable Amount}}{\$15,000 \text{ S, HH, QSS or } \$30,000 \text{ MFJ}} \times \text{Maximum Tax-Free Interest} = \text{Includible Interest}$$

The amount determined under the equation is then subtracted from the maximum tax-free interest amount to figure the amount of excludible savings bond interest.

$$\text{Maximum Tax-Free Interest} - \text{Includible Interest} = \text{Excludible Interest}$$

Let's continue with the earlier example but modify the facts slightly so that the taxpayer's MAGI exceeds the applicable amount. In the earlier example, we saw that \$2,550 of the \$3,000 interest is tax-free, provided the taxpayer is eligible to take the full interest exemption. However, the excludible interest would be less than \$2,550 if the taxpayer's MAGI exceeds the applicable amount.

Suppose the taxpayer has a MAGI of \$159,250 and is married filing a joint tax return for 2025. Since the taxpayer's filing status is married filing jointly, the equation used to determine the taxpayer's exclusion is as follows (the denominator is \$30,000 for married filing jointly):

$$\frac{\text{MAGI} - \text{Applicable Amount}}{\$30,000} \times \text{Maximum Tax-Free Interest} = \text{Includible Interest}$$

By substituting the actual values into the equation, we can see that the amount of the interest that must be included by the taxpayer because of their income is \$850, as shown below:

$$\frac{\$159,250 - \$149,250}{\$30,000} \times \$2,550 = \$850 \text{ Includible Interest}$$

Thus, the amount of interest excludible under the program is equal to the maximum tax-free interest minus the portion of it that must be included in income because of the taxpayer's MAGI. In this case, the taxpayer's excludible interest is \$1,700 (\$2,550 maximum tax-free interest – \$850 includible interest).

If a taxpayer's filing status is single, head of household, or qualifying surviving spouse, the equation used to determine the taxpayer's exclusion is as follows (the denominator is \$15,000 for single, head of household, or qualifying surviving spouse versus \$30,000 for married filing jointly):

$$\frac{\text{MAGI} - \text{Applicable Amount}}{\$15,000} \times \text{Maximum Tax-Free Interest} = \text{Includible Interest}$$

$$\text{Maximum Tax-Free Interest} - \text{Includible Interest} = \text{Excludible Interest}$$

When figuring the excludible interest amount, use Form 8815 Exclusion of Interest From Series EE and I U.S. Savings Bonds Issued After 1989. The excludible interest amount should be shown on Schedule B, line 3.

## Summary

Taxpayers may exclude some or all of the interest received on certain Series EE bonds and Series I bonds if he or she pays qualified education expenses at an eligible education institution and meets federal income tax filing status and income requirements. Qualified education expenses include tuition and fees, contributions to a qualified tuition program, and contributions to a Coverdell education savings account (ESA). Room and board expenses do not qualify. For purposes of the education savings bond program, an "eligible educational institution" includes virtually all accredited U.S. public, nonprofit, and proprietary post-secondary institutions.

Qualified education expenses must be adjusted, for purposes of the program. Adjusted qualified education expenses are qualified education expenses incurred reduced by tax-free benefits received, including the tax-free part of scholarships and fellowships, expenses used to figure the tax-free portion of Coverdell ESA and qualified tuition program distributions, any tax-free payments received as education assistance, and any expenses used in figuring the American opportunity and lifetime learning credits. Gifts and inheritances received, however, do not reduce qualified education expenses for purposes of the program.

When adjusted qualified education expenses equal or exceed the total amount of the proceeds of cashed-in bonds all bond interest received may be tax-free. However, if the total amount received is greater than the adjusted qualified education expenses, only a portion of the interest may be tax-free. Although the bond interest may be tax-free for an eligible taxpayer, a taxpayer's eligibility to exclude savings bond interest reduces as his or her income increases and is eliminated at certain higher income levels.

## CHAPTER 4 - EDUCATION TAX CREDITS

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### Introduction

Two important federal income tax credits are available to taxpayers who incur qualified education expenses. An American opportunity credit of up to \$2,500 per student is available for up to four years of postsecondary education. In addition, a lifetime learning credit of up to \$2,000 per return is available for all years of postsecondary education.

In this chapter, we will examine these two major federal tax credits for education.

### Chapter Learning Objectives

When you have completed this chapter you should be able to do the following with respect to the American opportunity credit and a lifetime learning credit:

- Recognize who is eligible to claim the tax credits;
- Identify the expenses considered qualified education expenses and those expenses that do not qualify;
- List the benefits for which qualified education expenses must be adjusted;
- Define an eligible educational institution;
- Calculate the available tax credits; and
- Apply the tax-benefit recapture rules.

### Two Tax Credits Offset Higher Education Costs

Two education tax credits are available to assist taxpayers in offsetting the costs of higher education: the American Opportunity Credit and the Lifetime Learning Credit. Although these education tax credits have certain similarities, they also differ from one another in several respects. Let's consider each of these important education tax credits, beginning with the American opportunity credit.

### American Opportunity Credit

A taxpayer whose modified adjusted gross income (MAGI) does not exceed certain limits may be able to claim an American opportunity tax credit of up to \$2,500 for qualified education expenses paid for each eligible student, part of which is a refundable credit. Thus, the maximum American opportunity credit for any taxpayer is equal to \$2,500 times the number of eligible students.

#### Overview of the American Opportunity Credit

The American opportunity credit is available only for the first four years of postsecondary education, during which time the student must be pursuing a degree or other recognized credential.

The following is an overview of the American opportunity credit:

Maximum credit	Up to \$2,500 credit per eligible student
Income limitations	Ineligible if MAGI is \$180,000 or more (married filing jointly) or \$90,000 or more (single, head of household, or qualifying surviving spouse)
Credit type	40% of the credit may be refundable; the balance is nonrefundable
Eligible education years	Available only for the first four years of postsecondary education
Maximum tax years	Available only for four tax years per eligible student
Degree requirement	Must be pursuing a degree or other recognized educational credential
Enrollment status	Must be enrolled at least half-time for at least one academic period beginning during the tax year
Qualified expenses	Tuition, required enrollment fees, and course materials (i.e. books, supplies, and equipment the student needs for a course of study, whether or not purchased from the educational institution)
Drug convictions	Student must not have been convicted of a felony for controlled substance possession or distribution
Academic periods	Payments made during the tax year for academic periods beginning during the tax year or in the first three months of the following year

### Eligibility to Claim an American Opportunity Credit

In general, an American opportunity credit can be claimed only by a taxpayer who meets certain requirements. The three requirements a taxpayer must meet to claim the credit are the following:

1. The taxpayer paid qualified education expenses for higher education;
2. The education expenses paid by the taxpayer were paid for an eligible student; and
3. The eligible student is the taxpayer, the taxpayer's spouse, or a dependent for whom the taxpayer claims on their tax return.

However, an American opportunity credit cannot be claimed if any of the following apply:

- The taxpayer's filing status is married filing separately;
- The taxpayer is listed as a dependent on another person's tax return;

- The taxpayer's MAGI is:
  - \$90,000 or more, and the taxpayer's filing status is single, head of household, or qualifying surviving spouse, or
  - \$180,000 or more, and the taxpayer's filing status is married filing jointly;
- The taxpayer or spouse was a nonresident alien for any part of the tax year, and the nonresident alien did not elect to be treated as a resident alien for tax purposes; or
- The taxpayer claims the lifetime learning credit for the same student in the same tax year.

### **Expenses Qualifying for an American Opportunity Credit**

The expenses that qualify for an American opportunity credit are those qualified education expenses the taxpayer pays for themselves, a spouse, or a dependent for whom the taxpayer claims. The qualified education expenses paid during the tax year must generally be for an academic period—semester, quarter, or other period of study, such as a summer school session—that begins during the tax year or in the first three months of the following tax year.

Many students borrow money to pay for education expenses. An American opportunity credit may be claimed for qualified education expenses that are paid with the proceeds of such a loan. A taxpayer may take the credit for the year in which the expenses are paid rather than the year in which the loan is repaid. The taxpayer may claim an American opportunity credit for qualified education expenses paid that are not refunded when a student withdraws.

### **Qualified Education Expenses for an American Opportunity Credit**

Qualified education expenses, for purposes of the American opportunity credit, are those expenses incurred at an eligible educational institution for:

- Tuition; and
- Related expenses required for enrollment or attendance at the institution, which include:
  - Student activity fees (only if they must be paid to the institution as a condition of enrollment or attendance), and
  - Expenses for books, supplies, and equipment needed for a course of study, whether or not purchased from the educational institution. (Note: This varies from the rules related to expenses for books, supplies, and equipment for purposes of the lifetime learning credit, which require the expenses to be paid to the educational institution to be deemed qualified.)

### **Eligible Educational Institution**

An eligible educational institution, for purposes of an American opportunity credit, is identical to an educational institution as the term is used in connection with a qualified tuition program, the education savings bond program, and the student loan interest deduction.

Thus, an eligible educational institution at which qualified education expenses are incurred is defined broadly to include the following:

- College;
- University;
- Vocational school; and
- Other post-secondary educational institutions.

Note: Certain other education tax benefits—Coverdell ESAs, for example—also consider expenses incurred in elementary and secondary educational institutions to be eligible.

### **Double Benefit Prohibited**

Federal tax rules prohibit a taxpayer from obtaining double education benefits. Accordingly, a taxpayer may not:

- Claim an American opportunity credit and a lifetime learning credit based on the same qualified education expenses;
- Claim an American opportunity credit or lifetime learning credit based on the same expenses used to figure the tax-free portion of a distribution from a Coverdell education savings account (ESA) or qualified tuition program (QTP); or
- Claim an American opportunity credit or lifetime learning credit based on qualified education expenses paid with tax-free educational assistance, such as a scholarship, grant, or assistance provided by an employer.

### **Adjustments to Qualified Education Expenses**

As noted above, federal law prohibits claiming an American opportunity credit or a lifetime learning credit for qualified education expenses the taxpayer paid with certain tax-free funds. Because of that proscription, the taxpayer is required to reduce the qualified education expenses, for purposes of the American opportunity (or lifetime learning) credit, by the amount of any received:

- Tax-free educational assistance; and
- Refunds.

### **Tax-Free Educational Assistance**

The tax-free educational assistance, whose receipt requires a reduction of qualified education expenses for purposes of the American opportunity credit, includes:

- The tax-free parts of scholarships and fellowships;
- Pell grants;
- Employer-provided educational assistance;
- Veterans' educational assistance; and
- Any other nontaxable payments—other than gifts or inheritances—received as educational assistance.

## Refunds

In some cases, qualified education expenses paid by a taxpayer are subsequently refunded. Dealing with such refunds may be as simple as subtracting the refund from total qualified education expenses, or it may require refiguring the tax credit, depending upon when the refund is received. (Note: A taxpayer is considered to have received a refund of expenses when an eligible educational institution refunds loan proceeds to the lender on behalf of the borrower.)

If a refund of qualified education expenses paid during the tax year is received before the taxpayer files their tax return for the year, the taxpayer should simply reduce the amount of the qualified education expenses by the amount of the refund. However, if a refund of qualified education expenses is received after the taxpayer files their tax return for the year, the taxpayer may be required to repay all or part of the credit.

If a refund of qualified education expenses is received subsequent to the taxpayer's filing of their tax return for the year, the taxpayer must refigure the American opportunity credit for the year as if the assistance or refund was received before the tax return was filed. Then, the taxpayer must refigure the tax liability using the revised credit amount. The increased tax liability is the amount the taxpayer must repay. The credit repayment should be added to the taxpayer's tax liability for the year in which they received the refund, in accordance with the tax return instructions for that year.

## Expenses That Do Not Qualify

Certain expenses, whether or not paid to the educational institution as a condition of enrollment or attendance, are not considered qualified education expenses for purposes of the American opportunity (or lifetime learning) credit.

Thus, qualified education expenses do not include amounts paid for:

- Insurance;
- Medical expenses, including student health fees;
- Room and board;
- Transportation; or
- Similar personal, living, or family expenses.

In addition, the term "qualified education expenses," as used with respect to an American opportunity credit or lifetime learning credit, generally excludes expenses relating to any course of instruction or other education that involves sports, games or hobbies, or any noncredit course. However, if the course of instruction or other education is part of the student's degree program, such expenses can qualify.

An eligible educational institution may combine all fees for an academic period into one amount. In such a case, if the taxpayer does not receive an allocation showing how much the taxpayer paid for qualified education expenses and how much was paid for personal expenses that do not qualify, the taxpayer should contact the educational institution. The educational institution is required to make the allocation and provide the taxpayer with the amount paid for qualified education expenses on **Form 1098-T Tuition Statement**.

## Eligible Students – American Opportunity Credit

To claim an American opportunity credit, the student for whom a taxpayer pays qualified education expenses must be an eligible student. An eligible student, for purposes of the American opportunity credit, is one who meets all of the following requirements:

- The student did not have expenses that were used to figure an American opportunity credit in any four earlier tax years (Note: An American opportunity credit can be claimed for only four tax years);
- The student had not completed the first four years of postsecondary education before the current tax year (Note: An American opportunity credit is available only for students who have not completed the first four years of postsecondary education before the end of the prior tax year);
- The student was enrolled at least half-time for at least one academic period in a program leading to a degree, certificate, or other recognized educational credential beginning in the current tax year; and
- The student has not been convicted of any federal or state felony for possessing or distributing a controlled substance as of the end of the tax year.

### Claiming a Dependent's Expenses

If there are qualified education expenses for a taxpayer's dependent during the tax year, either the taxpayer or the dependent may claim an American opportunity credit for those expenses. However, the same expenses cannot be used to claim an American opportunity credit by both the dependent and the taxpayer.

For a taxpayer to claim an American opportunity credit for their dependent's expenses, the taxpayer must also claim the dependent on Form 1040. If the taxpayer claims a dependent who is an eligible student, then only the taxpayer can claim the American opportunity credit based on that dependent's expenses; the dependent cannot claim the credit. However, if the taxpayer does not claim a dependent who is an eligible student, even if entitled to claim, the

dependent can then claim the American opportunity credit. In such a case, the taxpayer cannot claim the American opportunity credit based on the dependent's expenses.

### **Expenses Paid By the Dependent**

If a taxpayer claims an eligible student as a dependent, the taxpayer may treat any expenses paid by the dependent as if the taxpayer had paid them. Thus, the taxpayer should include any qualified education expenses paid by the dependent when figuring the amount of their American opportunity credit.

### **Expenses Paid By Others**

In some cases, qualified education expenses may be paid by someone other than the dependent or the taxpayer, a relative or former spouse, for example, directly to the educational institution. Such payments, for purposes of the American opportunity or lifetime learning credit, are deemed to be made to the student who then makes equal payments to the educational institution.

If the taxpayer claims a dependent (for whom such expenses are paid) on their tax return, the taxpayer is deemed to have paid the expenses for purposes of the American opportunity (or the lifetime learning) credit. Thus, the taxpayer may use those expenses to figure their American opportunity credit (or lifetime learning credit).

### **Tuition Reductions**

A taxpayer receives a "tuition reduction" if allowed to study tuition-free or for a reduced rate of tuition. A tuition reduction that is tax-free is referred to as a qualified tuition reduction. If a tuition reduction is taxable, the taxpayer is treated as having received a payment of that amount and, in turn, having paid it to the educational institution on behalf of the student. Accordingly, a tuition reduction that is taxable may be considered for purposes of figuring the American opportunity (or lifetime learning) credit.

A tuition reduction is qualified—and, therefore, tax-free—only if the taxpayer receives it from, and uses it at, an eligible educational institution. It is not necessary that the eligible educational institution at which the tuition reduction is used be the same eligible educational institution from which it was received.

In addition to the requirement that any tuition reduction be used at and received from an eligible educational institution in order for it to be qualified, certain other rules apply depending upon whether the education provided is at the:

- Undergraduate level; or
- Graduate level.

### **Tuition Reductions for Undergraduate-Level Education**

If the taxpayer receives a tuition reduction for undergraduate-level education, it is a qualified tuition reduction only if the taxpayer's relationship to the educational institution providing the benefit is one of those described below:

1. The taxpayer is an employee of the eligible educational institution;
2. The taxpayer was an employee of the eligible educational institution but has retired or left on disability;
3. The taxpayer is a widow or widower of an individual who died while an employee of the eligible educational institution or who retired or left on disability from that institution; or
4. The individual is the dependent child or spouse of the taxpayer described in (1) through (3) above.

Note: For purposes of the qualified tuition reduction, a child is a dependent child if under the age of 25 and both parents have died. In addition, a dependent child of divorced parents is treated as the dependent of both parents.

### Tuition Reductions for Graduate-Level Education

A tuition reduction received by the taxpayer for graduate education is considered qualified and, therefore, tax-free only if the following two requirements are met:

1. It is provided by an eligible educational institution; and
2. The taxpayer is a graduate student who performs teaching or research activities for the educational institution.

Any other tuition reductions for graduate education must be included in income.

### Figuring the American Opportunity Credit

The maximum amount of the American opportunity credit for each eligible student is \$2,500 and is equal to the sum of:

- 100% of the first \$2,000 of qualified education expenses paid by the taxpayer for the eligible student; plus
- 25% of the next \$2,000 of qualified education expenses the taxpayer paid for the eligible student.

Thus, to claim the full \$2,500 American opportunity credit for each eligible student, the taxpayer must have paid at least \$4,000 of qualified education expenses ( $100\% \times \$2,000 = \$2,000$ ;  $25\% \times \$2,000 = \$500$ ;  $\$2,000 + \$500 = \$2,500$ ). However, a taxpayer's American opportunity credit may be reduced based on their MAGI.

A taxpayer claims the American opportunity credit by completing *Form 8863 Education Credits (American Opportunity and Lifetime Learning Credits)*.

### Maximum American Opportunity Credit Subject to Income Limits Based on Filing Status

A taxpayer's American opportunity credit is gradually reduced if they file a single, head of household, or qualifying surviving spouse tax return and their MAGI exceeds \$80,000; it is eliminated completely for such a taxpayer at a \$90,000 MAGI. Similarly, if the MAGI of a taxpayer filing a joint return exceeds \$160,000, their maximum American

opportunity credit is gradually reduced until it is eliminated at a \$180,000 MAGI. These phase-out levels are not indexed for inflation. However, if the taxpayer files a married filing separate tax return, they do not qualify for this credit.

For most taxpayers, modified adjusted gross income (MAGI) is the taxpayer's adjusted gross income (AGI) as figured on their federal income tax return. However, in some cases, determining a taxpayer's MAGI for purposes of the American opportunity credit requires additional modifications.

When the taxpayer files Form 1040, the taxpayer's MAGI is their AGI, modified by adding back any of the following:

- Foreign earned income exclusion;
- Foreign housing exclusion;
- Foreign housing deduction;
- American Samoa residents' income exclusion; and
- Puerto Rico residents' income exclusion.

The equation that may be used to determine the reduction in the tentative American opportunity credit (tentative AOTC) is shown below:

$$\text{Tentative AOTC} \times \frac{\text{MAGI} - \text{Applicable Dollar Amt}}{\$10,000 (\$20,000 \text{ MFJ})} = \text{Reduction}$$

The amounts applicable to the American opportunity credit are as shown in the following chart:

Taxpayer's Filing Status	Applicable Amount	Credit Eliminated
Single, Head of Household, Qualifying Surviving Spouse	\$80,000	\$90,000
Married Filing Jointly (MFJ)	\$160,000	\$180,000

NOTE: If the taxpayer's filing status is married filing separately, the taxpayer does not qualify for this credit.

For example, suppose a taxpayer's tentative American opportunity credit is \$2,500 because they meet the requirements for the credit and have adjusted qualified education expenses amounting to \$4,000. However, the taxpayer files a single tax return and has a MAGI of \$82,500, i.e. \$2,500 more than the applicable amount. By substituting the appropriate values into the equation, we can see that the taxpayer's American opportunity credit is reduced by \$625, as shown below:

$$\$2,500 \times \frac{\$82,500 - \$80,000}{\$10,000} = \$625$$

Thus, by reducing the tentative credit by the reduction, we can see that the taxpayer's American opportunity credit, in this case, is \$1,875 (\$2,500 - \$625).

We can also determine the reduction in the tentative American opportunity credit if the taxpayer files a joint tax return and has a MAGI of \$165,000 by making similar substitutions. The difference is the applicable amount and the denominator of the fraction in the equation. In this example, the taxpayer's American opportunity credit is also reduced by \$625, as shown in the following equation:

$$\$2,500 \times \frac{\$165,000 - \$160,000}{\$20,000} = \$625$$

Instead of using the equation to determine the reduction in the tentative American opportunity credit and then subtracting the reduction, the reduced credit may be determined by using Form 8863.

### Refundable Part of the American Opportunity Credit

Part of the American opportunity credit is generally refundable<sup>5</sup> and part is nonrefundable<sup>6</sup>. Forty percent of the American opportunity credit is refundable for most taxpayers. Some taxpayers, however, cannot claim any part of the American opportunity credit as a refundable credit. The allowable credit for such taxpayers is limited to the non-refundable portion of the credit only.

A taxpayer does not qualify for the refundable portion of the American opportunity credit if items 1 (a, b, or c), 2, and 3 below apply:

1. The taxpayer is:
  - a. under age 18 at the end of the tax year, or
  - b. age 18 at the end of the tax year and has an earned income of less than one-half of their support, or
  - c. over age 18 and under age 24 at the end of the tax year and a full-time student, and has an earned income that was less than one-half of their support;
2. At least one of the taxpayer's parents was alive at the end of the tax year; and
3. The taxpayer is filing a return as single, head of household, qualifying surviving spouse, or married filing separately for the tax year (the taxpayer is not filing a joint return).

The term "earned income" includes a) wages, salaries, tips, and other taxable employee pay, b) net earnings from self-employment, and c) gross income received as a statutory employee. The term "support" includes all amounts spent to provide a person with food, lodging, clothing, education, medical and dental care, recreation, transportation, and similar necessities. A taxpayer is considered a full-time student if during any part of any five calendar months during the year, the taxpayer was enrolled as a full-time student at an eligible educational institution or took a full-time, on-farm training course given by such an institution or by a state, county, or local government agency.

## Credit Recapture

Some or all of the American opportunity credit may need to be repaid. If, after the taxpayer has filed their tax return on which an American opportunity credit was claimed, tax-free educational assistance for, or a refund of, an expense used to figure the credit on that return was received, the taxpayer may be required to repay all or part of the credit.

The tax return on which the credit was claimed does not change. However, the taxpayer must refigure the American opportunity credit for the year as if the assistance or refund was received during the year (rather than after the taxpayer's return was filed). Then, the taxpayer's tax liability must be refigured using the revised credit amount. The increased tax liability is the amount the taxpayer must repay. The repayment should be added to the taxpayer's tax liability for the year in which they received the assistance or refund. The instructions for the taxpayer's tax return for that year should be consulted.

## Lifetime Learning Credit

As noted earlier, taxpayers may also reduce their federal income tax liability by claiming the lifetime learning credit. A taxpayer whose MAGI does not exceed certain limits may be able to claim a nonrefundable lifetime learning tax credit of up to \$2,000 per return.

Note that the lifetime learning credit, unlike the American opportunity credit, is entirely nonrefundable and limited to no more than \$2,000 per tax return, rather than an amount per student.

### Overview of the Lifetime Learning Credit

The lifetime learning credit is available for an unlimited number of years (in contrast to the four-year limit applicable to the American opportunity credit) and is available for all years of postsecondary education as well as for courses to acquire or improve job skills. Additionally, the maximum annual lifetime learning credit is \$2,000 per return rather than \$2,500 per eligible student (the maximum American opportunity credit). Thus, the maximum taxpayer credit does not vary with the number of eligible students.

The following is an overview of the Lifetime learning credit:

Maximum credit	Up to \$2,000 credit per return
Income limitations	Ineligible if MAGI is \$180,000 or more (married filing jointly) or \$90,000 or more (single, head of household, or qualifying surviving spouse)
Credit type	Credit is nonrefundable (i.e. it is limited to the amount of the taxpayer's federal income tax liability)
Eligible education years	Available for all years of postsecondary education and for courses to acquire or improve job skills
Maximum tax years	Available for an unlimited number of tax years
Degree requirement	Student is not required to be pursuing a degree or other recognized credential
Enrollment status	Available for one or more courses
Qualified expenses	Tuition, required enrollment fees, and course materials (i.e. books, supplies, and equipment the student needs for a course of study, only if paid to the institution)
Drug convictions	Felony drug convictions do not disqualify
Academic periods	Payments made during the tax year for academic periods beginning during the tax year or in the first three months of the following year

### Eligibility to Claim a Lifetime Learning Credit

The basic eligibility requirements for claiming a lifetime learning credit are identical to the eligibility requirements for an American opportunity credit and are as follows:

1. The taxpayer paid qualified education expenses for higher education;
2. The education expenses paid by the taxpayer were paid for an eligible student; and
3. The eligible student is the taxpayer, the taxpayer's spouse, or a dependent for whom the taxpayer claims on their tax return.

The factors that would disqualify a taxpayer from claiming a lifetime learning credit are identical to the factors that would disqualify a taxpayer from claiming an American opportunity credit and are as follows:

- The taxpayer's filing status is married filing separately;
- The taxpayer is listed as a dependent on another person's tax return;

- The taxpayer's MAGI is:
  - \$90,000 or more, and the taxpayer's filing status is single, head of household, or qualifying surviving spouse, or
  - \$180,000 or more, and the taxpayer's filing status is married filing jointly;
- The taxpayer or spouse was a nonresident alien for any part of the tax year, and the nonresident alien did not elect to be treated as a resident alien for tax purposes; or
- The taxpayer claims the American opportunity credit for the same student in the same tax year.

### **Expenses Qualifying for a Lifetime Learning Credit**

The expenses that qualify for a lifetime learning credit are those qualified education expenses the taxpayer pays for themselves, a spouse, or a dependent for whom the taxpayer claims. The qualified education expenses paid during the tax year must generally be for an academic period—semester, quarter, or other period of study, such as a summer school session—that begins during the tax year or in the first three months of the following tax year.

Similar to an American opportunity credit, a lifetime learning credit may be claimed for qualified education expenses that are paid with the proceeds of a loan. A taxpayer may take the credit for the year in which the expenses are paid rather than the year in which the loan is repaid. The taxpayer may also claim a lifetime learning credit for qualified education expenses paid that are not refunded when a student withdraws.

### **Qualified Education Expenses for a Lifetime Learning Credit**

Qualified education expenses, for purposes of the lifetime learning credit, are those expenses incurred at an eligible educational institution for:

- Tuition; and
- Related expenses required for enrollment or attendance at the institution, which include:
  - Student activity fees (only if they must be paid to the institution as a condition of enrollment or attendance), and
  - Expenses for books, supplies, and equipment needed for a course of study, only if purchased from the educational institution. (Note: This contrasts with the rules related to expenses for books, supplies, and equipment for purposes of the American opportunity credit, which do not require these expenses to be paid to the educational institution to be deemed qualified.)

### **Eligible Educational Institution**

An eligible educational institution, for purposes of a lifetime learning credit, is identical to an educational institution as the term is used in connection with an American opportunity credit, qualified tuition program, the education savings bond program, and the student loan interest deduction.

Accordingly, an eligible educational institution at which qualified education expenses are incurred, for purposes of the lifetime learning credit, includes the following:

- College;
- University;
- Vocational school; and
- Other post-secondary educational institutions.

### **Double Benefit Prohibited**

A taxpayer is prohibited from obtaining double education benefits. Because of that rule, a taxpayer is prohibited from:

- Claiming a lifetime learning credit and an American opportunity credit based on the same qualified education expenses;
- Claiming a lifetime learning credit or American opportunity credit based on the same expenses used to figure the tax-free portion of a distribution from a Coverdell education savings account (ESA) or qualified tuition program (QTP); or
- Claiming a lifetime learning credit or American opportunity credit based on qualified education expenses paid with tax-free educational assistance, such as a scholarship, grant, or assistance provided by an employer.

### **Adjustments to Qualified Education Expenses**

A taxpayer cannot claim a lifetime learning credit or an American opportunity credit for qualified education expenses that they paid with certain tax-free funds. Thus, a taxpayer must reduce the qualified education expenses, for purposes of a lifetime learning credit (or American opportunity credit), by the amount of any received:

- Tax-free educational assistance; and
- Refunds.

### **Tax-Free Educational Assistance**

Similar to assistance that reduces qualified expenses when figuring an American opportunity credit, qualified education expenses are reduced, for purposes of a lifetime learning credit, by all of the following:

- The tax-free parts of scholarships and fellowships;
- Pell grants;
- Employer-provided educational assistance;

- Veterans' educational assistance; and
- Any other nontaxable payments—other than gifts or inheritances—received as educational assistance.

## Refunds

The way to deal with refunds of otherwise qualified education expenses for purposes of a lifetime learning credit is the same as it is for an American opportunity credit. Thus, if a refund of qualified education expenses paid during the tax year is received before the taxpayer files their tax return for the year, the taxpayer should simply reduce the amount of the qualified education expenses by the amount of the refund.

However, if a refund of qualified education expenses is received after the taxpayer files their tax return for the year, the taxpayer may be required to repay all or part of the credit. If a refund of qualified education expenses is received subsequent to the taxpayer's filing of their tax return for the year, the taxpayer must refigure the lifetime learning credit for the year as if the assistance or refund was received before the tax return was filed. Then, the taxpayer must refigure the tax liability using the revised credit amount. The increased tax liability is the amount the taxpayer must repay. The credit repayment should be added to the taxpayer's tax liability for the year in which they received the refund, in accordance with the tax return instructions for that year.

## Expenses That Do Not Qualify

Certain expenses, whether or not paid to the educational institution as a condition of enrollment or attendance, are not considered qualified education expenses for purposes of a lifetime learning credit (or American opportunity credit). Those education-related expenses that are not considered qualified education expenses are amounts paid for:

- Insurance;
- Medical expenses, including student health fees;
- Room and board;
- Transportation; or
- Similar personal, living, or family expenses.

As discussed earlier in connection with an American opportunity credit, the term "qualified education expenses," as used with respect to a lifetime learning credit, generally excludes expenses relating to any course of instruction or other education that involves sports, games or hobbies, or any noncredit course. However, if the course of instruction or other education is part of the student's degree program, then such expenses can qualify.

If an eligible educational institution combines fees for an academic period into one amount and the taxpayer does not receive an allocation showing how much was paid for qualified education expenses, the taxpayer should contact the educational institution. The educational institution must make the allocation and provide the taxpayer with information concerning the amount paid for qualified education expenses on **Form 1098-T Tuition Statement**.

## Eligible Students – Lifetime Learning Credit

To claim a lifetime learning credit, the student for whom a taxpayer pays qualified education expenses must be an eligible student. An eligible student, for purposes of a lifetime learning credit, is simply one who is enrolled in one or more courses at an eligible educational institution. (Note: The more stringent American opportunity credit requirements related to an eligible student do not apply to a lifetime learning credit.)

### Claiming a Dependent's Expenses

If there are qualified education expenses for a taxpayer's dependent during the tax year, either the taxpayer or the dependent may claim a lifetime learning credit for those expenses. However, the same expenses cannot be used to claim a lifetime learning credit by both the taxpayer's dependent and the taxpayer.

For a taxpayer to claim a lifetime learning credit for their dependent's expenses, the taxpayer must also claim the dependent on Form 1040. If the taxpayer claims a dependent who is an eligible student, then only the taxpayer can claim the lifetime learning credit based on that dependent's expenses; the dependent cannot claim the credit. However, if the taxpayer does not claim a dependent who is an eligible student, even if entitled to claim, the dependent can then claim the lifetime learning credit. If the dependent claims the lifetime learning credit, the taxpayer cannot also claim the lifetime learning credit based on the dependent's expenses.

### Expenses Paid By the Dependent

As in the case of an American opportunity credit, a taxpayer who claims an eligible student as a dependent may treat any expenses paid by the dependent as if the taxpayer had paid them. Thus, the taxpayer should include any qualified education expenses paid by the dependent when figuring the amount of their lifetime learning credit.

### Expenses Paid By Others

Payments made directly to the educational institution by someone other than the taxpayer or dependent—payments made by a grandparent, for example—to pay for an eligible student's qualified education expenses are considered, for purposes of a lifetime learning credit, to have been made to the student who then is assumed to have made equal payments to the educational institution. Thus, if a taxpayer claims the dependent on their tax return, the taxpayer is deemed to have paid the expenses for purposes of the lifetime learning credit (since the taxpayer is assumed to have paid any education expenses paid by the dependent), and the taxpayer may use those expenses to figure the credit.

### Tuition Reductions

A taxpayer is deemed to have received a "tuition reduction" if allowed to study tuition-free or for a reduced rate of tuition. A tuition reduction that is tax-free is referred to as a qualified tuition reduction. If a tuition reduction is taxable,

the taxpayer is treated as having received a payment of that amount and, in turn, having paid it to the educational institution on behalf of the student. Accordingly, a tuition reduction that is taxable may be considered for purposes of figuring a lifetime learning credit.

A tuition reduction is qualified—and, therefore, tax-free—only if the taxpayer receives it from, and uses it at, an eligible educational institution. It is not necessary that the eligible educational institution at which the tuition reduction is used be the same eligible educational institution from which it was received.

In addition to the requirement that any tuition reduction be used at and received from an eligible educational institution for it to be qualified, certain other rules apply depending upon whether the education provided is at the:

- Undergraduate level; or
- Graduate level.

### **Tuition Reductions for Undergraduate-Level Education**

If the taxpayer receives a tuition reduction for undergraduate-level education, it is a qualified tuition reduction only if the taxpayer's relationship to the educational institution providing the benefit is one of those described below:

1. The taxpayer is an employee of the eligible educational institution;
2. The taxpayer was an employee of the eligible educational institution but has retired or left on disability;
3. The taxpayer is a widow or widower of an individual who died while an employee of the eligible educational institution or who retired or left on disability from that institution; or
4. The individual is the dependent child or spouse of the taxpayer described in (1) through (3) above.

Note: For purposes of the qualified tuition reduction, a child is a dependent child if under the age of 25 and both parents have died. In addition, a dependent child of divorced parents is treated as the dependent of both parents.

### **Tuition Reductions for Graduate-Level Education**

A tuition reduction received by the taxpayer for graduate education is considered qualified and, therefore, tax-free only if the following two requirements are met:

1. It is provided by an eligible educational institution; and
2. The taxpayer is a graduate student who performs teaching or research activities for the educational institution.

Any other tuition reductions for graduate education must be included in income.

### **Figuring the Lifetime Learning Credit**

The maximum annual amount of lifetime learning credit a taxpayer may claim is \$2,000 per return. The credit is equal to 20% of the first \$10,000 of qualified education expenses paid for all eligible students but may be reduced based on the taxpayer's MAGI, as discussed in the following subsection.

A taxpayer claims the lifetime learning credit by completing *Form 8863 Education Credits (American Opportunity and Lifetime Learning Credits)*. Unlike an American opportunity credit, no part of a lifetime learning credit is refundable.

#### Maximum Lifetime Learning Credit Subject to Income Limits Based on Filing Status

A taxpayer's lifetime learning credit is gradually reduced if they file a single, head of household, or qualifying surviving spouse tax return and their MAGI exceeds \$80,000; it is eliminated completely for such a taxpayer at a \$90,000 MAGI. Similarly, if the MAGI of a taxpayer filing a joint return exceeds \$160,000, their maximum lifetime learning credit is gradually reduced until it is eliminated at a \$180,000 MAGI. These phase-out levels are not indexed for inflation. However, if the taxpayer files a married filing separate tax return, they do not qualify for this credit.

As discussed earlier in connection with the American opportunity credit, MAGI for most taxpayers is the taxpayer's AGI as figured on their federal income tax return. However, in some cases, determining a taxpayer's MAGI for purposes of the lifetime learning credit requires additional modifications.

The taxpayer's MAGI is their AGI, modified by adding back any of the following:

- Foreign earned income exclusion;
- Foreign housing exclusion;
- Foreign housing deduction;
- American Samoa residents' income exclusion; and
- Puerto Rico residents' income exclusion.

The equation that may be used to determine the reduction in the tentative lifetime learning credit is shown below:

$$\text{Tentative Lifetime Learning Credit} \times \frac{\text{MAGI} - \text{Applicable Amt}}{\$10,000 (\$20,000 MFJ)} = \text{Reduction}$$

The amounts applicable to the lifetime learning credit are as shown in the following chart:

Taxpayer's Filing Status	Applicable Amount	Credit Eliminated
Single, Head of Household, Qualifying Surviving Spouse	\$80,000	\$90,000
Married Filing Jointly (MFJ)	\$160,000	\$180,000
NOTE: If the taxpayer's filing status is married filing separately, the taxpayer does not qualify for this credit.		

For example, suppose a taxpayer's tentative lifetime learning credit is \$2,000 because they meet the requirements for the credit and have adjusted qualified education expenses amounting to \$10,000. However, the taxpayer files a joint tax return and has a MAGI of \$165,000, i.e. \$5,000 more than the applicable amount. By substituting the appropriate values into the equation, we can see that the taxpayer's lifetime learning credit is reduced by \$500, as shown below:

$$\$2,000 \times \frac{\$165,000 - \$160,000}{\$20,000 \text{ MFJ}} = \$500 \text{ reduction}$$

Thus, by reducing the tentative credit by the reduction, we can see that the taxpayer's lifetime learning credit, in this case, is \$1,500 (\$2,000 – \$500).

The reduction in a lifetime learning credit for an eligible taxpayer filing other than a joint tax return can be determined similarly by using the appropriate applicable amount. In such a case, however, the denominator of the fraction is \$10,000 rather than \$20,000 for married filing jointly.

Instead of using the equation shown above to determine the reduction in the tentative lifetime learning credit and then subtracting the reduction from the tentative credit, the reduced lifetime learning credit may be determined by using Form 8863.

### Lifetime Learning Credit Recapture

Some or all of a lifetime learning credit may need to be repaid. If, after the taxpayer has filed their tax return on which a lifetime learning credit was claimed, tax-free educational assistance for, or a refund of, an expense the taxpayer used to figure the credit was received, the taxpayer may be required to repay all or part of the credit.

The tax return on which the credit was claimed does not change. However, the taxpayer must refigure the lifetime learning credit for the year as if the assistance or refund was received during the year (rather than after the taxpayer's return was filed). Then, the taxpayer's tax liability must be refigured using the revised credit amount. The increased tax liability is the amount the taxpayer must repay. The repayment should be added to the taxpayer's tax liability for the year in which they received the assistance or refund. The instructions for the taxpayer's tax return for that year should be consulted.

## Summary

Two somewhat similar tax credits are available to taxpayers to help them offset some of their costs of higher education. Known as the American opportunity credit and the lifetime learning credit, they are identical to one another in certain respects and different in other respects.

Both tax credits are phased out at higher taxpayer incomes. A taxpayer whose income does not exceed the level at which phase-out begins may be able to claim an American opportunity tax credit of up to \$2,500—part of which is a refundable credit—for qualified education expenses paid for each eligible student. A nonrefundable lifetime learning credit of up to \$2,000 per tax return is similarly available to eligible taxpayers for qualified education expenses.

In order to claim either of these education tax credits, a taxpayer must meet three requirements:

1. The taxpayer paid qualified education expenses of higher education;
2. The education expenses paid by the taxpayer were paid for an eligible student; and
3. The eligible student is the taxpayer, the taxpayer's spouse, or a dependent for whom the taxpayer claimed on his or her tax return.

In addition to meeting the three basic requirements to claim the education tax credits, a taxpayer must avoid certain other factors that will disqualify him or her from claiming the credits. A taxpayer is ineligible to claim the education tax credits if any of the following apply:

- The taxpayer's filing status is married filing separately;
- The taxpayer is listed as a dependent on another person's tax return;
- The taxpayer's modified adjusted gross income (MAGI) is \$90,000 or more for single, head of household, or qualifying surviving spouse, and \$180,000 or more for married filing joint; or
- The taxpayer or spouse was a nonresident alien for any part of the tax year and the nonresident alien did not elect to be treated as a resident alien for tax purposes.

Although qualified education expenses for both tax credits include tuition and student activity fees (if paid to the institution as a condition for enrollment or attendance), the treatment of expenses for books, supplies, and equipment varies depending on the credit. For an American opportunity credit, the expenses for books, supplies, and equipment needed for a course of study are considered qualified education expenses, whether or not the books, supplies, and equipment are purchased from the educational institution. For a lifetime learning credit, however, the expenses incurred for books, supplies, and equipment needed for a course of study are considered qualified education expenses only if the expenses are paid to the institution. Taxpayers must reduce the qualified education expenses, for purposes of the credits by any tax-free educational assistance or refunds they receive.

The eligible educational institutions at which qualified education expenses must be incurred in order to claim either education tax credit include colleges, universities, vocational schools, and other post-secondary educational institutions.

Certain education expenses are not considered qualified education expenses for purposes of the tax credits. The education-related expenses that are not considered qualified education expenses are expenses for insurance, medical expenses (including student health fees), room and board, transportation, and similar personal, living, or family expenses.

The definition of "eligible student," as used in connection with the tax credits, varies depending on which education tax credit is being considered. An eligible student, for purposes of the American opportunity credit, is one who:

- Did not have expenses that were used to figure an American opportunity credit in any four earlier tax years;
- Had not completed the first four years of postsecondary education before the current tax year;
- Was enrolled at least half-time for at least one academic period in a program leading to a degree, certificate, or other recognized educational credential beginning in the current tax year; and
- Has not been convicted of any federal or state felony for possessing or distributing a controlled substance as of the end of the tax year.

In contrast, an eligible student, for purposes of a lifetime learning credit, is simply one who is enrolled in one or more courses at an eligible educational institution. Unlike the American opportunity credit, which is available for four years, the lifetime learning credit is available for all tax years.

The maximum amount of the tax credit available to taxpayers depends on which credit is being claimed. The maximum American opportunity credit for each eligible student is \$2,500. To obtain the maximum American opportunity credit, the taxpayer must have incurred at least \$4,000 in qualified education expenses since the benefit is equal to the sum of 100% of the first \$2,000 and 25% of the next \$2,000 of qualified education expenses. Forty percent of the American opportunity credit is refundable for most taxpayers.

The maximum lifetime learning credit is \$2,000 per return and is equal to 20% of the first \$10,000 of qualified education expenses. A taxpayer cannot claim an American opportunity credit and a lifetime learning credit in the same year based on the same qualified education expenses. The maximum amount that may be claimed under either tax credit is reduced for higher-income taxpayers and is eliminated at specified modified adjusted gross income levels. The applicable MAGI level at which the education tax credits are phased out depends on the taxpayer's filing status. For both education tax credits, the phaseout is if MAGI is between \$80,000 and \$90,000 (\$160,000 and \$180,000 MFJ) and no credit if MAGI is \$90,000 or more (\$180,000 or more MFJ)). These phaseout limits are not adjusted for inflation.

Some or all of the education tax credits may need to be repaid if tax-free educational assistance for, or a refund of, an expense used to figure the credit on a tax return is subsequently received.



## CHAPTER 5 - TAXATION OF EDUCATIONAL ASSISTANCE, STUDENT LOAN INTEREST, LOAN CANCELLATIONS AND REPAYMENTS

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### Introduction

Federal tax law addresses various types of educational assistance and student loans. In this chapter, we will examine these education-related issues and will consider the tax treatment of:

- Scholarships, fellowships, need-based education grants, and qualified tuition reductions;
- Interest paid on student loans; and
- Student loan cancellations and repayment assistance.

### Chapter Learning Objectives

When you have completed this chapter you should be able to:

- Identify the tax treatment of educational assistance, including:
  - Scholarships and fellowships,
  - Fulbright grants,
  - Need-based education grants,
  - Veterans' education benefits, and
  - Tuition reductions;
- Calculate the student loan interest deduction available to a taxpayer; and
- Apply the applicable federal income tax rules to student loan cancellations and repayment assistance.

### Educational Assistance

Educational assistance is available in various forms, including scholarships, fellowships, need-based education grants—Pell grants, for example—and tuition reductions. Such assistance may be tax-free if it meets certain requirements.

A scholarship is an amount paid or allowed to, or for the benefit of, a student at an educational institution to aid in the pursuit of undergraduate or graduate studies. A fellowship is an amount paid for the benefit of an individual to aid in the pursuit of study or research. A taxpayer receives a tuition reduction when he or she is permitted to study for a reduced rate of tuition or tuition free.

## Scholarships and Fellowships

Some or all of a scholarship (including an athletic scholarship) or fellowship may be tax-free or taxable, depending on the nature of the expense paid with the scholarship or fellowship and whether or not the taxpayer is a degree candidate. Thus, a scholarship or fellowship is tax-free only if:

- The taxpayer is a candidate for a degree at an eligible educational institution;
- The taxpayer uses the scholarship or fellowship to pay qualified education expenses; and
- The scholarship or fellowship does not represent payment for teaching, research, or other services required as a condition for receiving it.

### Tax-Free Scholarships and Fellowships for Degree Candidates

If the student is a degree candidate, the scholarship or fellowship payment is tax-free provided such payment is used for tuition, fees, books, supplies, or equipment. However, scholarship or fellowship payments used for room and board or travel constitute taxable income to the recipient, whether or not a degree candidate.

In contrast to the tax-free nature of scholarships and fellowships received by degree candidates when used for specified purposes, scholarships and fellowships received by taxpayers who are not degree candidates are taxable.

A degree candidate is a student who attends:

- A primary or secondary school or who is pursuing a degree at a college or university; or
- An educational institution that:
  - Provides a program that is acceptable for full credit towards a bachelor's or higher degree, or offers a program of training to prepare students for gainful employment in a recognized occupation, and
  - Is authorized under federal or state law to provide such a program and is accredited by a nationally recognized accreditation agency.

### Eligible Educational Institution

An eligible educational institution is one whose primary function is the presentation of formal instruction and which normally:

- Maintains a regular faculty and curriculum; and
- Has a regularly enrolled body of students in attendance at the place where it carries on its educational activities.

### Qualified Education Expenses

Qualified education expenses, for purposes of tax-free scholarships and fellowships, are expenses for the following:

- Tuition and fees required to enroll at or attend an eligible educational institution; and
- Course-related expenses that are required of all students in the course of instruction at the eligible institution, such as:
  - Fees,
  - Books,
  - Supplies, and
  - Equipment.

In order for such expenses to be deemed qualified education expenses, the terms of the scholarship or fellowship cannot require that it be used for other purposes, such as room and board, or specify that it cannot be used for tuition or course-related expenses. Scholarships or fellowships containing such stipulations are taxable.

Certain expenses, however, are not considered qualified education expenses. Such nonqualified expenses include the cost of:

- Room and board;
- Travel;
- Research;
- Clerical help; and
- Equipment and other expenses that are not required for enrollment in or attendance at an eligible educational institution.

### **Taxable Scholarships and Fellowships**

A scholarship or fellowship is taxable if it does not meet the requirements applicable to non-taxable scholarships and fellowships. Accordingly, the following amounts received are taxable:

- Amounts used to pay expenses that are not considered qualified education expenses;
- Any payments received for services; and
- Scholarship prizes.

### **Amounts Used to Pay Non-Qualifying Expenses**

A scholarship amount the taxpayer uses to pay any expense that does not qualify is taxable. Such amounts are taxable, even if the expense is a fee the student must pay to the institution as a condition of enrollment or attendance.

### **Payments for Services Constitute Taxable Income**

In some cases, a scholarship or fellowship may require the recipient to teach, perform research or provide other services as a condition for its receipt. Unless an exception applies, the part of any scholarship or fellowship representing payment for teaching, research, or other services required as a condition for receiving the scholarship must be included in income. Such payments are taxable even if all candidates for a degree must perform the services in order to receive the degree.

Certain exceptions apply to the taxability of the part of scholarships and fellowships that represent payments for teaching, research, or providing other services. Such exceptions are applicable to payments received under the National Health Service Corps Scholarship Program and the Armed Forces Health Professions Scholarship and Financial Assistance Program but only if the student:

- Is a candidate for a degree at an eligible educational institution; and
- Uses that part of the scholarship or fellowship to pay qualified education expenses.

### **Scholarship Prizes**

A scholarship prize is a scholarship won in a contest. Such scholarship prizes are fully taxable unless the recipient meets the requirements applicable to a tax-free scholarship and fellowship discussed above.

### **Reporting Scholarships and Fellowships**

The requirement that a student report a scholarship or fellowship depends on:

- Whether the student must file a tax return; and
- Whether any part of the student's scholarship or fellowship is taxable.

If the student's only income is a completely tax-free scholarship or fellowship, the student is not required to file a tax return, and no reporting is necessary. However, if all or part of the student's scholarship or fellowship is taxable and the student is required to file a tax return, he or she must report the taxable amount.

The applicable line on which a taxpayer reports taxable scholarship or fellowship income depends on which return is filed.

## **Other Types of Educational Assistance**

In addition to scholarships and fellowships, other types of educational assistance may be available to a student. Among the more common types of educational assistance available are:

- Fulbright grants;
- Pell grants and other need-based education grants;

- Payments to service academy cadets;
- Veterans' benefits; and
- Tuition reductions.

### **Fulbright Grants**

A Fulbright grant is generally treated as a scholarship or fellowship when determining how much of the grant is tax-free. The taxpayer is required only to report the taxable amount on his or her tax return.

### **Pell Grants and Other Need-Based Education Grants**

Pell grants and other Title IV need-based education grants are treated as scholarships for purposes of determining their tax treatment. They are tax-free to the extent used for qualified education expenses during the period for which a grant is awarded. Accordingly, the taxpayer should report only the taxable amount on his or her tax return.

### **Service Academy Cadet Payments**

Payments a U.S. service academy cadet receives at an armed services academy are considered payments for personal services and must be reported to the taxpayer on Form W-2. The taxpayer must include this amount in income in the year received unless an exception applies, as discussed earlier under Payments for Services Constitute Taxable Income above.

### **Veterans' Benefits**

Payments that a taxpayer receives for education, training, or subsistence under a law administered by the Department of Veterans Affairs, i.e. the VA, are tax-free. Such payments are not includible as income on the taxpayer's federal income tax return.

As discussed earlier in connection with various education benefits, a taxpayer receiving veterans' benefits may be required to reduce the amount of education expenses that qualify for a specific benefit by some or all of the taxpayer's VA payments.

### **Tuition Reduction**

Tuition reductions were discussed earlier in connection with the American opportunity credit and other similar benefits. As noted at that time, a taxpayer receives a "tuition reduction" if allowed to study tuition free or for a reduced rate of tuition.

Tuition reductions may be taxable or tax-free. A tuition reduction that is tax-free is referred to as a qualified tuition reduction. If a tuition reduction is taxable, the taxpayer is treated as having received a payment of that amount and, in turn, having paid it to the educational institution on behalf of the student.

A tuition reduction is qualified—and, therefore, tax-free—only if the taxpayer receives it from, and uses it at, an eligible educational institution. It is not necessary that the eligible educational institution at which the tuition reduction is used be the same eligible educational institution from which it was received.

In addition to the requirement that any tuition reduction be used at and received from an eligible educational institution in order for it to be qualified, certain other rules apply depending upon whether the education provided is at the:

- Undergraduate level; or
- Graduate level.

### **Tuition Reductions for Undergraduate-Level Education**

If the taxpayer receives a tuition reduction for undergraduate-level education, it is a qualified tuition reduction only if the taxpayer's relationship to the educational institution providing the benefit is described below:

1. The taxpayer is an employee of the eligible educational institution;
2. The taxpayer was an employee of the eligible educational institution but has retired or left on disability;
3. The taxpayer is a widow or widower of an individual who died while an employee of the eligible educational institution or who retired or left on disability from that institution; or
4. The individual is the dependent child or spouse of the taxpayer described in (1) through (3) above.

Note: For purposes of the qualified tuition reduction, a child is a dependent child if under the age of 25 and both parents have died. In addition, a dependent child of divorced parents is treated as the dependent of both parents.

### **Tuition Reductions for Graduate-Level Education**

A tuition reduction received by a taxpayer for graduate education is considered qualified and, therefore, tax-free only if the following two requirements are met:

1. It is provided by an eligible educational institution; and
2. The taxpayer is a graduate student who performs teaching or research activities for the educational institution.

Any other tuition reductions for graduate education must be included in income.

### **Reporting Tuition Reductions**

A taxable tuition reduction should be included as wages in box 1 of the taxpayer's Form W-2. That amount should be reported on the taxpayer's Form 1040, on the wages/salaries line (Total amount from Form(s) W-2, box 1 line).

## Student Loan Interest Deduction

Although interest, other than mortgage interest, is not generally tax-deductible, a special deduction is allowed for interest payments made on a student loan used solely to pay higher education expenses. The maximum student loan interest tax deduction is \$2,500 but is subject to certain limitations. The deduction for student loan interest is taken as an adjustment to income. Because of that, a taxpayer may claim the student loan interest deduction even if they do not itemize deductions.

The following is an overview of the student loan interest deduction:

Maximum benefit	Tax deduction of up to \$2,500
Qualifying loan	Taxpayer's student loan: <ul style="list-style-type: none"> <li>• Must have been taken out solely to pay qualified education expenses; and</li> <li>• Cannot be from a related person or a qualified employer plan</li> </ul>
Qualifying student	The student must be: <ul style="list-style-type: none"> <li>• The taxpayer, the taxpayer's spouse, or the taxpayer's dependent; and</li> <li>• Enrolled at least half-time in a degree program</li> </ul>
Deduction time limit	A taxpayer can deduct interest paid during the remaining period of their student loan
Limit on MAGI	A taxpayer's modified adjusted gross income (MAGI) for the year must be less than the annual threshold (adjusted annually for inflation)

## Student Loan Interest Defined

Student loan interest is defined, for purposes of the deduction, as interest paid by a taxpayer during the year on a qualified student loan. It includes both required interest payments and voluntary interest payments.

### Qualified Student Loan

A "qualified student loan" is a loan taken by the taxpayer solely to pay qualified education expenses that were:

- For the taxpayer, the taxpayer's spouse, or a person who was the taxpayer's dependent when the loan was taken out;
- Paid or incurred within a reasonable period of time before or after the taxpayer took out the loan; and
- For education provided during an academic period for an eligible student.

However, loans from certain sources are not considered qualified student loans, and the interest on them is not deductible as student loan interest. Thus, even if loan proceeds are used to pay qualified education expenses, loans from a person related to the taxpayer or from a qualified employer plan are not considered qualified student loans.

A "related person," as the term is used in connection with a qualified student loan, includes the taxpayers:

- Spouse;
- Brothers and sisters;
- Half-brothers and half-sisters;
- Ancestors;
- Lineal descendants; and
- Certain corporations, partnerships, trusts, and exempt organizations.

### **Dependents for Student Loan Interest Deductions**

For purposes of the student loan interest deduction, a taxpayer's dependent is defined as a person who is a:

- Qualifying child<sup>7</sup>; or
- Qualifying relative<sup>8</sup>.

### **Exceptions to Usual Dependent Rules**

Certain exceptions apply to the general rules applicable to dependents for purposes of the student loan interest deduction. Those exceptions, which apply only with respect to the student loan interest deduction, are as follows:

- A person can be the taxpayer's dependent even if the taxpayer is the dependent of another taxpayer;
- A person can be the taxpayer's dependent even if the person files a joint return with a spouse; and
- A person can be the taxpayer's dependent even if the person had gross income for the year equal to or greater than \$5,200 for 2025.

### **Reasonable Period of Time**

The student loan interest deduction rules require that the qualified education expenses for which the student loan was taken out must have been paid or incurred within a reasonable period of time before or after the loan was taken.

A taxpayer will have met this requirement if:

- The expenses are paid with the proceeds of student loans that are part of a federal postsecondary education loan program; or
- The expenses relate to a specific academic period and the loan proceeds are dispersed:
  - No earlier than 90 days before the start of the academic period, and
  - No later than 90 days after the end of the academic period.

If neither of these situations applies, a reasonable period of time usually is determined based on all the relevant facts and circumstances. An "academic period," as that term is used in connection with the student loan interest deduction, includes a semester, trimester, quarter, or other period of study, e.g. a summer school session, as determined by the educational institution. If the educational institution does not have academic terms but uses credit hours or clock hours instead, each payment period can be treated as an academic period.

### **Eligible Student**

An "eligible student," for purposes of the student loan interest deduction, is defined as a student who is enrolled at least half-time—taking at least half the normal full-time workload for their course of study, in other words—in a program leading to a degree, certificate, or other recognized educational credential.

## **Qualified Education Expenses**

Qualified education expenses, for purposes of the student loan interest deduction, are the total costs of attending an eligible educational institution, including graduate school. (See Eligible Educational Institution below.) The expenses included as qualified education expenses include amounts paid for:

- Tuition and fees;
- Room and board;
- Books, supplies, and equipment; and
- Other necessary expenses, such as transportation.

Room and board expenses qualify only to the extent they do not exceed the greater of:

- The room and board allowance, determined by the eligible educational institution, included in the cost of attendance for federal financial aid purposes; or
- The actual amount charged if the student is residing in housing owned or operated by the eligible educational institution.

### **Eligible Educational Institution**

The term "eligible educational institution" includes virtually all accredited public, nonprofit, and proprietary postsecondary institutions. As such, it includes any college, university, vocational school, or other postsecondary educational institution eligible to participate in a student aid program administered by the U.S. Department of Education.

In addition, for purposes of the student loan interest deduction, an educational institution also includes an institution conducting an internship or residency program leading to a degree or certificate from an institution of higher

education, a hospital, or a healthcare facility offering postgraduate training. In order for an educational institution to be considered an eligible educational institution, it need only meet the applicable criteria during the academic periods for which the student loan was incurred. Thus, the subsequent loss of eligibility by the institution does not affect the taxpayer's student loan interest deduction.

### **Adjustments to Qualified Education Expenses**

Taxpayers are required to reduce their qualified education expenses, for purposes of the student loan interest deduction, by the total amount paid for such expenses by the following tax-free items:

- Employer-provided educational assistance;
- Any tax-free distribution of earnings from a Coverdell education savings account;
- Tax-free distribution of earnings from a qualified tuition program;
- U.S. savings bond interest is excluded from income because it was used to pay qualified education expenses;
- The tax-free part of scholarships and fellowships;
- Veterans' educational assistance; and
- Any other nontaxable payments, other than gifts or inheritances, received as educational assistance.

### **Amounts Included as Interest**

The amounts considered interest, for purposes of the student loan interest deduction, include simple interest on the loan and—provided all other applicable requirements are met—the following items:

- Loan origination fee, i.e. the one-time fee charged by the lender when the loan is made. If loan origination fees are not included in the amount reported on the taxpayer's Form 1098-E, the taxpayer can use any reasonable method to allocate the loan origination fees over the term of the loan;
- Capitalized interest, i.e. unpaid interest added by the lender to the outstanding principal balance;
- Interest on revolving lines of credit if the borrower uses the line of credit only to pay qualified education expenses;
- Interest on refinanced student loans. However, if the taxpayer refinances a qualified student loan for more than the original loan amount and uses the additional amount for any purpose other than qualified education expenses, the taxpayer cannot deduct any interest paid on the refinanced loan; and
- Voluntary interest payments, i.e. payments made on a qualified student loan during a period when interest payments are not required.

## Amounts Not Included as Interest

Certain amounts may not be included as interest for purposes of the student loan interest deduction. Accordingly, a taxpayer cannot claim a student loan interest deduction for:

- Interest paid on a loan if the taxpayer is not legally obligated to make interest payments;
- Loan origination fees which are payments for property or services provided by the lender, such as commitment fees or processing costs; and
- Interest the taxpayer paid on a loan to the extent payments were made through the taxpayer's participation in the National Health Service Corps Loan Repayment Program or other loan repayment assistance programs.

## Eligibility to Claim the Deduction

A taxpayer can claim the student loan interest deduction if all of the following requirements are met:

- The taxpayer's filing status is any filing status other than married filing separately;
- No one else claims the taxpayer as a dependent on their tax return;
- The taxpayer is legally obligated to pay interest on a qualified student loan; and
- The taxpayer paid interest on a qualified student loan.

Note that if the interest on a qualified student loan on which the taxpayer is legally obligated to make interest payments is actually made by another person, the taxpayer is deemed to have received the payments from such other person and, in turn, to have paid the interest himself or herself.

The taxpayer cannot deduct as interest on a student loan any amount that is an allowable deduction under any other provision of the tax law, such as home mortgage interest.

## Determining the Student Loan Interest Deduction

A taxpayer's student loan interest deduction is generally equal to the smaller of:

- \$2,500; or
- The interest paid by the taxpayer on a qualified student loan during the tax year.

The amount thus determined, however, may be gradually reduced or eliminated based on the taxpayer's filing status and modified adjusted gross income (MAGI), as discussed below.

The student loan interest deduction is an adjustment to income, making it available to taxpayers whether or not they itemize deductions. To claim the deduction, the taxpayer should enter the allowable amount on the appropriate line of their tax return.

### Income and Filing Status may Affect Student Loan Interest Deduction

The amount of a taxpayer's student loan interest deduction is gradually reduced or eliminated based on the taxpayer's filing status and MAGI. These phase-out levels are indexed for inflation. Accordingly, the 2025 applicable amounts for purposes of the student loan interest deduction are:

Taxpayer's Filing Status	Applicable Amount	Deduction Eliminated
Single (S), Head of Household (HH), Qualifying Surviving Spouse (QSS)	\$85,000	\$100,000
Married Filing Jointly (MFJ)	\$170,000	\$200,000
<b>NOTE:</b> If the taxpayer's filing status is married filing separately (MFS), the taxpayer does not qualify for this deduction.		

For a taxpayer whose MAGI is within the range of incomes requiring that the student loan interest deduction be reduced—taxpayers whose MAGI is greater than the applicable amount but less than the amount at which the student loan interest deduction is eliminated, in other words—determining the reduced deduction is relatively simple. Doing so requires that the taxpayer's student loan interest deduction (before the phaseout)—referred to in this course as the tentative loan interest deduction—be multiplied by a fraction, the numerator of which is the amount of the taxpayer's income in excess of the applicable MAGI and the denominator of which is the range over which the phaseout occurs.

Thus, the following equation is used to determine the reduction in the amount of the loan interest the taxpayer may deduct:

$$\text{Tentative loan interest deduction} \times \frac{\text{MAGI} - \text{Applicable amount}}{\$15,000 \text{ } (\$30,000 \text{ MFJ})} = \text{Reduction in loan interest deduction}$$

Since the equation yields the amount of reduction in the loan interest deduction to which a taxpayer is entitled, the result of the equation must be subtracted from the tentative loan interest deduction to determine the taxpayer's deduction. For example, suppose a single taxpayer's tentative loan interest deduction is \$2,500 and she has a MAGI of \$90,000 for 2025. By substituting the appropriate values in the equation, we can see that the reduction in her student loan interest deduction is \$833, as shown in the following equation:

$$\$2,500 \times \frac{\$90,000 - \$85,000}{\$15,000} = \$833$$

Because the taxpayer's student loan interest deduction in the example is reduced by \$833, her deduction is \$1,667 (\$2,500 – \$833).

### **MAGI Defined for Student Loan Interest Deduction**

For most taxpayers, MAGI is the taxpayer's adjusted gross income (AGI) before subtracting any deduction for student loan interest. However, in some cases determining a taxpayer's MAGI requires additional modifications.

When the taxpayer files IRS Form 1040 the taxpayer's MAGI, for purposes of the student loan interest deduction, is their AGI without taking the student loan interest deduction into account. It is further modified, if necessary, by adding back any of the following:

- Foreign earned income exclusion;
- Foreign housing deduction;
- Foreign housing exclusion;
- American Samoa residents' income exclusion; and
- Puerto Rico residents' income exclusion.

## **Student Loan Cancellations and Repayment Assistance**

A taxpayer's student loan may be forgiven or the taxpayer may receive loan repayment assistance if the taxpayer meets certain criteria. While a taxpayer responsible for making loan payments must generally include loan repayment assistance or loan cancellation in income, such cancellations and assistance may be tax-free if the taxpayer fulfills certain requirements.

A taxpayer cannot deduct the interest paid on a student loan to the extent payments were made through their participation in either of these programs.

### **Tax-Free Student Loan Cancellation**

If a taxpayer's student loan is canceled, the taxpayer will not be required to include any amount in income, provided the loan meets all of the following requirements:

- It was made by a qualified lender;
- It was designed to assist the taxpayer in attending an eligible educational institution; and
- It contains a provision that all or part of the debt will be canceled if the taxpayer works:
  - For a certain period of time,

- In certain professions, and
- For any of a broad class of employers.

**Note:** The cancellation of a taxpayer's loan will not qualify for tax-free treatment if it is canceled because of services the taxpayer performed for the educational institution that made the loan or other organization that provided the funds. In most cases, the cancellation of a student loan made by an educational institution because of services the taxpayer performed for that institution or another organization that provided the funds for the loan must be included in gross income on the taxpayer's tax return.

### Discharge of certain student loan indebtedness

Generally, if a taxpayer is responsible for making loan payments, and the loan is canceled or repaid by someone else, the taxpayer must include the amount that was canceled or paid on their behalf in gross income. However, in certain circumstances, the taxpayer may be able to exclude amounts from gross income as a result of:

1. Excluded if the creditor canceled the debt due to the performance of services.
2. Excluded if due to death or total and permanent disability. *Tax Cuts and Jobs Act of 2017*: Discharges of loans after December 31, 2017, and before January 1, 2026.
3. Excludes **any** amount which would be includible in gross income by reason of the discharge (in whole or in part) for discharges of student loans. *American Rescue Plan Act of 2021*: Discharges of loans after December 31, 2020, and before January 1, 2026.

### Qualified Lenders

In order for a taxpayer's student loan cancellation to be tax-free, the loan must have been made by a qualified lender. A qualified lender, for purposes of the tax-free student loan cancellation provision of the law, includes:

1. The United States, or an instrumentality of the United States;
2. A state, territory, or possession of the United States, or the District of Columbia, or any political subdivision thereof;
3. A public benefit corporation that is tax-exempt under section 501(c)(3):
  - a. Which has assumed control of a state, county, or municipal hospital, and
  - b. Whose employees are considered public employees under state law; and
4. An eligible educational institution, if the loan is made:
  - a. As part of an agreement with an entity described in 1, 2, or 3 above, under which the funds to make the loan were provided to the educational institution, or

- b. Under a program of the educational institution that is designed to encourage its students to serve in occupations with unmet needs or in areas with unmet needs where the services provided by the students are for or under the direction of a governmental unit or a tax-exempt section 501(c)(3) organization.

A section 501(c)(3) organization is any corporation, community chest, fund, or foundation organized and operated exclusively for one of the following purposes:

- Charitable;
- Religious;
- Educational;
- Literary;
- Scientific;
- Testing for public safety;
- Fostering national or international amateur sports competition (but only if none of its activities involve providing athletic facilities or equipment); or
- The prevention of cruelty to children or animals.

### **Eligible Educational Institutions**

In addition to the loan being made by a qualified lender to qualify for tax-free treatment of its cancellation, the purpose of the loan must have been to assist the taxpayer in attending an eligible educational institution. An eligible educational institution, for purposes of the tax-free student loan cancellation provision, is an educational institution that:

- Maintains a regular faculty and curriculum; and
- Normally has a regularly enrolled body of students in attendance at the place where it carries on its educational activities.

### **Refinanced Loans**

If the taxpayer refinanced a student loan with another loan from an eligible educational institution or a tax-exempt organization, the loan will be considered made by a qualified lender if it meets certain requirements. In order for the refinanced loan to be considered made by a qualified lender—and, therefore, eligible for tax-free cancellation—it must be made under a program of the refinancing organization that:

- Is designed to encourage students to serve in occupations with unmet needs or in areas with unmet needs; and
- Requires services of the students under the direction of a governmental unit or a tax-exempt section 501(c)(3) organization.

## Tax-Free Student Loan Repayment Assistance

Student loan repayment assistance constitutes taxable income to the taxpayer unless the assistance meets certain criteria. Accordingly, student loan repayments made to the taxpayer are tax-free if the taxpayer received them for any of the following:

- The National Health Service Corps (NHSC) Loan Repayment Program;
- A state education loan repayment program eligible for funds under the Public Health Service Act; or
- Any other state loan repayment or loan forgiveness program that is intended to provide for the increased availability of health services in underserved or health professional shortage areas.

### Summary

Taxpayers can receive scholarships, fellowships, need-based education grants, and qualified tuition reductions as well as student loan cancellations and repayment assistance, all of which may be tax-free. In addition, federal income tax law provides certain tax benefits for interest paid on student loans.

A scholarship or fellowship is tax-free only if it meets specified criteria: a) the taxpayer is a degree candidate at an eligible education institution, b) the scholarship or fellowship is used to pay qualified education expenses, and c) the funds received are not payments for teaching or performing research of other services.

However, a scholarship or fellowship is taxable if used to pay expenses that don't qualify, if received for services or if it is a prize. In addition, the part of any scholarship or fellowship representing payment for teaching, research, or other services that are required as a condition for receiving the scholarship must be included in income.

Tuition reductions may be taxable or tax-free. A tuition reduction that is tax-free is referred to as a qualified tuition reduction. If a tuition reduction is taxable, the taxpayer is treated as having received a payment equal to the amount of the tuition reduction and, in turn, having paid it to the educational institution on behalf of the student.

Although non-mortgage interest is not generally tax-deductible, taxpayers are allowed a special deduction of up to \$2,500 for interest payments made on student loans used to pay higher education expenses. The student loan interest deduction is taken as an adjustment to income, making the deduction available whether or not the taxpayer itemizes deductions.

Taxpayers can claim the student loan interest deduction if a) the taxpayer's filing status is other than married filing separately, b) the taxpayer is not claimed as a dependent on another person's tax return, c) the taxpayer is legally obligated to pay interest on a qualified student loan, and d) the taxpayer paid interest on a qualified student loan.

If a taxpayer's student loan is forgiven or the taxpayer receives loan repayment assistance, such benefits may be tax-free if certain requirements are met.

## GLOSSARY

### Glossary

Adjusted qualified education expenses	<p>Adjusted qualified education expenses are total qualified education expenses reduced by any tax-free education assistance including:</p> <ul style="list-style-type: none"> <li>• The tax-free portion of scholarships and fellowships;</li> <li>• Veterans' educational assistance;</li> <li>• Pell grants;</li> <li>• Employer-provided educational assistance; and</li> <li>• Other non-taxable payments, except gifts and inheritances, received as educational assistance.</li> </ul>
American opportunity tax credit	An American opportunity tax credit is a credit of up to \$2,500 for qualified education expenses paid for each eligible student, part of which is refundable, that is available to a taxpayer whose income does not exceed certain limits.
Applicable amount	The amount of a taxpayer's modified adjusted gross income (MAGI) at which a tax benefit begins to phase out.
Beneficiary (Coverdell ESA)	<p>A Coverdell education savings account beneficiary may be any individual who is age 18 or less. The beneficiary age limit does not apply if the beneficiary is a special needs beneficiary.</p>
Contract plan	A contract plan is a prepaid tuition plan under which a taxpayer agrees to purchase a specified number of years of tuition. Contract plans are generally priced so that the purchase price is smaller when the plan beneficiaries are younger children. Such contract plans assume that, when plan beneficiaries are younger children, more time is available to the educational institution to invest the funds before the beneficiary actually attends college.
Coverdell education savings account (ESA)	A Coverdell education savings account (ESA) is a trust or custodial account designed to enable taxpayers to save education funds on a tax-deferred basis and make tax-free withdrawals to pay for qualified education expenses.
Education savings bond program	The education savings bond program is a federal tax benefit under which eligible taxpayers may exclude the interest on certain U.S. savings bonds when they incur qualified education expenses at an eligible educational institution.

Education savings plan	An education savings plan is a qualified tuition program under which a taxpayer invests money into a special account established for a designated beneficiary.
Eligible educational institution	An eligible educational institution is an educational institution at which certain expenses for enrollment or attendance would be considered qualified education expenses. Educational institutions that are considered "eligible" vary, depending on the type of education tax benefit.
Excess distribution (Coverdell ESA)	An excess distribution from a Coverdell ESA is a distribution that exceeds the taxpayer's adjusted qualified education expenses.
Fellowship	A fellowship is an amount paid for the benefit of an individual to aid in the pursuit of study or research.
Lifetime learning tax credit	A lifetime learning tax credit is a nonrefundable tax credit of up to \$2,000 per tax return for qualified education expenses paid by a taxpayer whose income does not exceed certain limits.
Modified adjusted gross income (MAGI)	Modified adjusted gross income (MAGI), for purposes of various education tax benefits, is the taxpayer's adjusted gross income (AGI) adjusted to add back certain amounts excluded from income for tax purposes.
Nonrefundable tax credit	A nonrefundable tax credit is a tax credit that is limited in amount to the taxpayer's income tax liability for the taxable year.
Pell grant	A Pell grant is a need-based education grant.
Prepaid tuition plan	A prepaid tuition plan is one of two optional approaches available under a qualified tuition program. Under a prepaid tuition plan a taxpayer pays now for future education. Thus, a taxpayer may lock in the costs of attending college - college attendance that might not occur for many years in the future.
Prepaid unit plan	A prepaid unit plan is a prepaid tuition plan, under which a taxpayer purchases units representing a fixed percentage of tuition. For example, one unit may represent 1% of a year's tuition. In such plans, although every purchaser pays the same price, the price of a prepaid unit generally increases annually.
Qualified education expenses	Qualified education expenses are expenses related to enrollment and/or attendance at an eligible educational institution. Education expenses may vary, depending on the type of education tax benefit.

Qualified student loan	A qualified student loan is a loan taken by the taxpayer solely to pay the taxpayer's, spouse's or dependents' qualified education expenses paid or incurred within a reasonable period of time before or after the taxpayer took out the loan for education provided during an academic period for an eligible student.
Qualified tuition program	Qualified tuition programs are programs offered by each of the 50 states and the District of Columbia pursuant to which a taxpayer may contribute funds for the purpose of paying a designated beneficiary's qualified education expenses at a postsecondary educational institution. A qualified tuition program offers participants certain federal tax benefits and, depending upon the state, may also offer additional state tax benefits.
Qualified tuition reduction	A tuition reduction that is tax-free is referred to as a qualified tuition reduction.
Recapture	The requirement that a tax credit or deduction be repaid.
Refundable tax credit	A refundable tax credit is a tax credit that may be recovered by the taxpayer regardless of the amount of the taxpayer's income tax liability for the taxable year.
Scholarship	A scholarship is an amount paid or allowed to, or for the benefit of, a student at an educational institution to aid in the pursuit of undergraduate or graduate studies.
Scholarship prize	A scholarship prize is a scholarship won in a contest.
Student loan interest deduction	The student loan interest deduction is a deduction of up to \$2,500 allowed for interest payments made on a student loan used solely to pay higher education expenses.
Taxable scholarships and fellowships	Taxable scholarships and fellowships are educational assistance programs under which amounts are used to pay expenses that do not qualify for tax-exemption, any payments received by the taxpayer for services and scholarships awarded as prizes.
Tax-free educational assistance	Tax-free educational assistance, whose receipt generally requires a reduction of qualified education expenses, includes the tax-free parts of scholarships and fellowships, Pell grants, employer-provided educational assistance, veterans' educational assistance and other nontaxable payments received as educational assistance.
Tuition reduction	A taxpayer receives a "tuition reduction" if allowed to study tuition free or for a reduced rate of tuition.
Veterans' education benefits	Payments that a taxpayer receives for education, training or subsistence under a law administered by the Department of Veterans Affairs. Such benefits are tax-free.



## APPENDIX A

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### 529 Plan State Income Tax Treatment

State	529 Plan State Income Tax Treatment*
Alabama	Contributions to an Alabama 529 plan up to \$5,000 per year (\$10,000 for married taxpayers filing jointly) are deductible in computing state tax.
Alaska	Not applicable. The state has no personal income tax.
Arizona	Contributions to Arizona and non-Arizona 529 plans up to \$2,000 per year (\$4,000 for married taxpayers filing jointly) are deductible in computing state tax.
Arkansas	Contributions to an Arkansas 529 plan up to \$5,000 per year (\$10,000 for married taxpayers filing jointly) are deductible in computing state tax. Contributions greater than these amounts may be carried forward to the next succeeding four (4) tax years. Contributions to non-Arkansas 529 plans of up to \$3,000 (\$6,000 total per married couple) are deductible in computing Arkansas state income tax, provided the taxpayer has not deducted the contribution on another state's income tax return. Rollover contributions from an out-of-state 529 plan to an Arkansas 529 plan of up to \$7,500 (\$15,000 per married couple) are deductible in the tax year the contribution is rolled over.
California	No deduction or credit is allowed.
Colorado	Certain contributions to a Colorado 529 plan are deductible in computing state tax. Beginning January 1, 2025, state tax deductions will be limited to \$25,400 per taxpayer, per beneficiary for single filers, or \$38,100 per tax filing, per beneficiary for joint tax return filers. For income tax years on or after January 1, 2026, the cap will be annually adjusted by the percentage change in the combined average annual costs of tuition and room and board for all state institutions of higher education. The Working Families College Savings Act offers a Colorado tax credit for employers who make contributions to CollegenInvest savings plans owned by their employees. The available tax credit is 20% of the amount contributed to a CollegenInvest 529 account, up to \$500 per employee (for a \$2,500 employer contribution).
Connecticut	Contributions to a Connecticut 529 plan up to \$5,000 per year (\$10,000 for married taxpayers filing jointly) are deductible in computing state tax. Five-year carry forward of excess contributions.

Delaware	Contributions to a Delaware 529 plan up to \$1,000 per year (\$2,000 for married taxpayers filing jointly). The deduction will not apply to individuals with a federal adjusted gross income greater than \$100,000 (or \$200,000 for joint returns).
District of Columbia	Contributions to a DC 529 plan up to \$4,000 per year (\$8,000 for married taxpayers filing jointly) are deductible in computing state tax. Five-year carry forward of excess contributions.
Florida	Not applicable. The state has no personal income tax.
Georgia	Contributions to a Georgia 529 plan up to \$4,000 per beneficiary per year for single filing status (\$8,000 for joint filers) are deductible in computing state tax.
Hawaii	No deduction or credit is allowed.
Idaho	Contributions to an Idaho 529 plan up to \$6,000 per year (\$12,000 for married taxpayers filing jointly) are deductible in computing state tax.
Illinois	Contributions to an Illinois 529 plan up to \$10,000 per year (\$20,000 for married taxpayers filing jointly) are deductible in computing state tax. Five-year carry forward of excess contributions.
Indiana	A 20% tax credit on up to \$1,500 per year (\$750 for married couples filing separately) in contributions to an Indiana 529 plan can be claimed in computing state tax.
Iowa	Contributions to an Iowa 529 plan up to \$5,800 per year per beneficiary (\$11,600 for married taxpayers filing jointly) are deductible in computing state tax. Indexed for inflation.
Kansas	Contributions to Kansas and non-Kansas 529 plans up to \$3,000 per year (\$6,000 for married taxpayers filing jointly) are deductible in computing state tax.
Kentucky	No deduction or credit is allowed.
Louisiana	Contributions to a Louisiana 529 plan up to \$2,400 per year (\$4,800 for married taxpayers filing jointly) are deductible in computing state tax. An unused cap amount with an active account may be carried forward to increase the cap in later tax years. Contribution maximums are doubled for an account opened for an eligible needy, non-related beneficiary.

Maine	Contributions to a Maine 529 plan up to \$1,000 per year per beneficiary for single or married taxpayers filing jointly are deductible in computing state tax.
Maryland	Contributions to a Maryland 529 plan up to \$2,500 per beneficiary per year (\$5,000 for married taxpayers filing jointly) are deductible in computing state tax. A 10-year carry forward applies to excess contributions to a Maryland College Investment Plan, and an unlimited carry forward applies to excess contributions to a Maryland Prepaid College Trust.
Massachusetts	Contributions to a Massachusetts 529 savings plan up to \$1,000 per year (\$2,000 for married taxpayers filing jointly) are deductible in computing state tax.
Michigan	Contributions to a Michigan 529 savings plan up to \$5,000 per year (\$10,000 for married taxpayers filing jointly) are deductible in computing state tax. Contributions must be reduced by any qualified withdrawals during the year for purposes of determining the deductible amount. Contributions to the Michigan Education Trust are fully deductible.
Minnesota	Contributions to a Minnesota 529 savings plan up to \$1,500 per year (\$3,000 for married taxpayers filing jointly) are deductible in computing state tax.
Mississippi	Contributions to a Mississippi 529 savings plan up to \$10,000 per year (\$20,000 for married taxpayers filing jointly) are deductible in computing state tax. Contributions to the Mississippi Prepaid Affordable College Tuition Program are fully deductible.
Missouri	Contributions to a Missouri and non-Missouri 529 plan up to \$8,000 per year (\$16,000 for married taxpayers filing jointly) are deductible in computing state tax.
Montana	Contributions to a Montana 529 plan up to \$3,000 per year (\$6,000 for married taxpayers filing jointly) are deductible in computing state tax.
Nebraska	Contributions to a Nebraska 529 plan up to \$10,000 per year for single taxpayers or married taxpayers filing jointly and \$5,000 per year for married taxpayers filing separately are deductible in computing state tax.
Nevada	Not applicable. The state has no personal income tax.
New Hampshire	Not applicable. The state has no personal income tax.

New Jersey	Contributions to a New Jersey 529 plan up to \$10,000 per year for single taxpayers or married taxpayers filing jointly with gross income of \$200,000 or less are deductible in computing state tax.
New Mexico	Contributions to a New Mexico 529 Plan are fully deductible in computing state tax.
New York	Contributions to a New York 529 plan up to \$5,000 per year (\$10,000 for married taxpayers filing jointly) are deductible in computing state tax.
North Carolina	No deduction or credit is allowed.
North Dakota	Contributions to a North Dakota 529 plan up to \$5,000 per year (\$10,000 for married taxpayers filing jointly) are deductible in computing state tax.
Ohio	Contributions to an Ohio 529 plan up to \$4,000 per beneficiary per year (any filing status) are deductible in computing state tax. Unlimited carry forward of excess contributions.
Oklahoma	Contributions to an Oklahoma 529 plan up to \$10,000 per year (\$20,000 for married taxpayers filing jointly) are deductible in computing state tax. Five-year carry forward of excess contributions.
Oregon	Contributions to an Oregon 529 plan up to \$180 per year (\$360 for married taxpayers filing jointly) are deductible in computing state tax. Indexed for inflation. Four-year carry forward of excess contributions.
Pennsylvania	Contributions to Pennsylvania and non-Pennsylvania 529 plans up to the gift tax annual exclusion amount per beneficiary are deductible in computing state income tax. The spouse must have personal income in the case of a split gift.
Rhode Island	Contributions to a Rhode Island 529 plan up to \$500 per year (\$1,000 for married taxpayers filing jointly, provided they each make contributions to their own account) are deductible in computing state tax. Unlimited carry forward of excess contributions.
South Carolina	Contributions to a South Carolina 529 plan are fully deductible in computing state tax.
South Dakota	Not applicable. The state has no personal income tax.
Tennessee	Not applicable. The state has no personal income tax.

Texas	Not applicable. The state has no personal income tax.
Utah	Contributions to the Utah 529 plan of up to \$2,490 per beneficiary by an individual, and up to \$4,980 per beneficiary by a married couple filing jointly, are eligible for a 4.55% credit against Utah income tax. The maximum credit is \$113.30 per beneficiary for single taxpayers and \$226.56 per beneficiary for joint filers. Indexed for inflation.
Vermont	Contributions to a Vermont 529 plan of up to \$2,500 per beneficiary per year by an individual, and up to \$5,000 per beneficiary per year if the contributors are married and file a joint tax return, are eligible for a 10% Vermont income tax credit (up to \$250 per beneficiary per individual taxpayer or \$500 per beneficiary for married taxpayers filing jointly).
Virginia	Contributions to a Virginia 529 plan up to \$4,000 per account per year are deductible in computing state tax. Unlimited carry forward of excess contributions. Contributions to a Virginia 529 plan by taxpayers at least 70 years old are fully deductible.
Washington	Not applicable. The state has no personal income tax.
West Virginia	Contributions to a West Virginia 529 plan are fully deductible in computing state tax.
Wisconsin	Contributions to a Wisconsin 529 plan of up to \$5,130 per beneficiary by an individual or married couple filing jointly, and up to \$2,560 per year by married couple filing separately, are deductible in computing Wisconsin taxable income. Indexed for inflation.
Wyoming	Not applicable. The state has no personal income tax.

Source: [www.savingforcollege.com](http://www.savingforcollege.com)

\*State laws and amounts are subject to change, and some states' amounts are indexed for inflation.



## **APPENDIX B**

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### **Qualified Tuition Program vs. Coverdell Education Savings Account Comparison**

Qualified Tuition Program vs. Coverdell Education Savings Account Comparison

	Qualified Tuition Program (QTP)	Coverdell Education Savings Account (ESA)
Eligibility	All are eligible to contribute regardless of income	Any individual whose modified adjusted gross income is less than \$110,000 (\$220,000 for joint return taxpayers) may contribute
Maximum contributions per designated beneficiary	Amount needed to meet college expenses	\$2,000/year, reduced based on MAGI
Contribution tax treatment	Non-deductible	Non-deductible
Earnings tax treatment	Tax-deferred	Tax-deferred
Distribution tax treatment	<ul style="list-style-type: none"> <li>• Tax-exempt for qualified <b>higher</b> education expenses</li> <li>• Gain included in distributions in excess of adjusted qualified higher education expenses is taxable and subject to a 10% additional tax unless an exception applies</li> </ul>	<ul style="list-style-type: none"> <li>• Tax-exempt for qualified education expenses</li> <li>• Gain included in distributions in excess of adjusted qualified education expenses is taxable and subject to a 10% additional tax unless an exception applies</li> </ul>
Qualified education expenses	<ul style="list-style-type: none"> <li>• Tuition and fees</li> <li>• Books, supplies, and equipment</li> <li>• Expenses for special needs services required by a special needs beneficiary</li> <li>• Room and board if attending at least half time</li> </ul>	Qualified elementary and secondary education expenses: <ul style="list-style-type: none"> <li>• Tuition and fees</li> <li>• Books, supplies, and equipment</li> <li>• Academic tutoring</li> <li>• Special needs services for a special needs beneficiary</li> <li>• Room and board</li> <li>• Uniforms and transportation</li> <li>• Supplementary items and services e.g. extended day programs</li> </ul>

		<ul style="list-style-type: none"> <li>• Costs for purchase of computer technology, equipment, or Internet access</li> </ul> <p>Qualified higher education expenses:</p> <ul style="list-style-type: none"> <li>• Tuition and fees</li> <li>• Books, supplies, and equipment</li> <li>• Expenses for special needs services required by a special needs beneficiary</li> <li>• Room and board if attending at least half time</li> </ul>
<p>Eligible educational institution</p>	<p>Any college, university, vocational school, or other postsecondary educational institution eligible to participate in a student aid program administered by the U.S. Department of Education</p>	<ul style="list-style-type: none"> <li>• <b>Eligible elementary or secondary schools</b> are any public, private, or religious school that provides elementary or secondary education (kindergarten through grade 12), as determined under state law</li> <li>• <b>Eligible postsecondary schools</b> are any college, university, vocational school, or other postsecondary educational institution eligible to participate in a student aid program administered by the U.S. Department of Education</li> </ul>
<p>Tax treatment of investment losses</p>	<p><b>NOTE: For 2018 through 2025, a loss may <u>not</u> be claimed.</b></p>	<p><b>NOTE: For 2018 through 2025, a loss may <u>not</u> be claimed.</b></p> <p>Losses on Coverdell ESA investments may be taken only when all amounts from the account have been distributed and the total distributions are less than the taxpayer's unrecovered basis. In the event of distributions from more than one Coverdell ESA during the year the taxpayer must combine the information from all such accounts in order to determine taxable earnings for the year.</p>

	<p>Losses on QTP investments may be taken only when all amounts from the account have been distributed and the total distributions are less than the taxpayer's unrecovered basis. In the event of distributions from more than one QTP account during the year the taxpayer must combine the information from all such accounts in order to determine taxable earnings for the year.</p> <p>A loss may be claimed as a miscellaneous itemized deduction on Schedule A (Forms 1040 or 1040-NR) subject to the 2% of adjusted gross income limit.</p> <p>The TCJA temporarily suspends all miscellaneous itemized deductions that are subject to the 2-percent floor.</p>	<p>A loss may be claimed as a miscellaneous itemized deduction on Schedule A (Forms 1040 or 1040-NR) subject to the 2% of adjusted gross income limit.</p> <p>The TCJA temporarily suspends all miscellaneous itemized deductions that are subject to the 2-percent floor.</p>
<p>Beneficiary age limitations</p>	<p>No age limits apply to QTPs</p>	<ul style="list-style-type: none"> <li>• Coverdell ESA contributions may be made only before the beneficiary reaches age 18 unless he or she is a special needs beneficiary</li> <li>• Coverdell ESA accounts must be distributed before the beneficiary reaches age 30 unless the beneficiary is a special needs beneficiary</li> </ul>
<p>Rollovers</p>	<p>Distributed amounts are not taxable if rolled over to another QTP for the benefit of the same beneficiary or a member of the beneficiary's family within 60 days of distribution</p>	<p>Distributed amounts are not taxable if rolled over to another Coverdell ESA for the benefit of the same beneficiary or a member of the beneficiary's family <b>who is under age 30</b> (except for a special needs beneficiary) within 60 days of distribution</p>