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The New College Try

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As college costs increase with no end in sight, more and more of your clients are struggling to find ways to lighten the tuition load. Luckily, there exist several beneficial tax deductions, credits and scholarships that can help.

ABOVE-THE-LINE DEDUCTIONS

The Economic Growth and Tax Relief Reconciliation Act of 2001 created the option for parents of a dependent child or an independent student with earned income to take an above-the-line deduction (the taxpayer does not need to itemize) of up to $4,000 for education tuition and qualifying fees. Though it expired in 2006, the recently passed Tax Relief and Health Care Act of 2006 reinstated the above-the-line education tuition and qualifying fees deduction for 2006, and extended it for the 2007 tax year as well.

The deduction limit of $4,000 is reduced to $2,000 for single taxpayers with an adjusted gross income above $65,000 ($130,000 for joint filers), and is reduced to nothing for those with an AGI in excess of $80,000 ($160,000 for joint filers). Unlike most phase-outs, the reductions in the maximum amount are not pro-rata across the income thresholds, but instead are simply reduced in steps from $4,000 to $2,000 to nothing.

Parents with dependent children or independent students earning income who claim the above-the-line deduction for education costs cannot also claim the Hope Scholarship Credit or Lifetime Learning Credit for that same student. In addition, the deduction is only applicable for higher education costs (both undergraduate and graduate degrees).

For many, the above-the-line education deduction represents not only an appealing deduction, but the only attainable deduction available for higher education. The Hope Scholarship Credit and Lifetime Learning Credit phase out entirely at $110,000 of AGI for joint filers and $55,000 for all others.

However, taxpayers who have higher education expenses in 2007 and have income low enough to be eligible for more than one education tax benefit (including independent tax filing status for students of high-income parents) will need to compare the net effect of each of the options to determine which one — the above-the-line deduction for educational tuition and qualifying fees, the Hope Scholarship Credit or Lifetime Learning Credit, as applicable — produces the greatest tax savings. Fortunately, this can be accomplished easily in most instances with any popular tax preparation software or with the assistance of a tax professional.

HOPE SCHOLARSHIP CREDIT

The Hope Credit may be utilized by parents who claim their child as a dependent, or by non-dependent students themselves. The student must have earned income, but they do not have to provide for 50 percent or more of their own care.

The HSC is an applicable tax credit for qualified tuition and related expenses of each student in a taxpayer’s family who is enrolled at least part-time in the first two years of post-secondary education leading to a degree, certificate or other recognized educational credential. This is an actual tax credit that reduces the amount of income tax that you may have to pay. Unlike a deduction, which reduces the amount of income subject to tax, a tax credit directly reduces the tax itself.

The amount that may be claimed as a credit is generally equal to 100 percent of the first $1,100 of the taxpayer’s out-of-pocket expenses for each student’s qualified tuition and related expenses, plus 50 percent of the next $1,100 of the taxpayer’s out-of-pocket expenses for each student’s qualified tuition and related expenses. Therefore, the maximum possible credit allowed will be $1,650. The amount a taxpayer may claim with the HSC in 2007 is gradually reduced for taxpayers who have modified AGI between $45,000 and $55,000 ($95,000 to $110,000 for married couples filing jointly).

If qualified, an individual can now also claim a Hope Credit or Lifetime Learning Credit in conjunction with the qualified tax-free distributions in a 529 college savings plan on behalf of the same student, as long as the deduction is not used for the same expenses for which the credit was claimed. The same rule for the Hope Scholarship Credit and the Lifetime Learning Credit apply in conjunction with Coverdell Educational Savings Account distributions as well.

LIFETIME LEARNING CREDIT

The Lifetime Learning Credit may be utilized by parents who claim their child as a dependent or by non-dependent students themselves. The LLC is an applicable tax credit for qualified tuition and related expenses for students in the taxpayer’s family. The amount that may be claimed as a credit is equal to 20 percent of the taxpayer’s first $10,000 of out-of-pocket qualified expenses for all the students in the taxpayer’s family. As a result, the maximum credit a taxpayer may claim is $2,000. This is also an actual tax credit that reduces the amount of income tax that you may have to pay.

If the taxpayer is claiming a Hope Credit for a particular student, none of that student’s expenses for the year may be applied towards the LLC. The family income limits to qualify are the same as for the HSC in 2007.

Unlike the HSC, with the LLC students are not required to be enrolled part-time in one of the first two years of post-secondary education. This means that this credit is available (assuming qualified income) for a student taking even one course at a local community college, or for most any course utilized to acquire or improve job skills.

The LLC, unlike the HSC, is calculated on a per-family basis, rather than on a per-student basis. With the LLC, the maximum available credit does not vary with the number of students in a family.

LOAN INTEREST DEDUCTION

Certain parents or independent students may qualify for a maximum student-loan interest deduction of up to $2,500. One may take this regardless of whether it is itemized on Schedule A of the 1040. The income limitation (2006) for married couples is an AGI of between $105,000 to $135,000 (it phases out above $135,000), and for all other filers (except married filing separately, in which case one would not be eligible), it is $50,000 to $65,000.

This deduction is applicable, if income qualified, for qualifying educational loans for you, your spouse, or a dependent. The person for whom loan expenses are eligible for a deduction must be at least a part-time student. This deduction is not applicable for interest payments that are deductible elsewhere (i.e., home equity loans, etc.).

Federal loans, including Stafford, Parent Federal Plus and federal consolidation, are eligible up to a maximum based on other criteria. Personal loans, including bank, home equity (including first or second mortgages), margin and life insurance loans, should in most cases, if qualified, be an allowable interest deduction. Intra-family loans would not qualify.

Even when parents make too much money to qualify for such an interest deduction, if a dependent student has earned income, the interest on student loans in the student’s name (i.e., Stafford loans) is deductible by the student (assuming, as is likely in that scenario, that the student qualifies income-wise).

Only the party legally obligated to repay the educational loan may take the interest deduction. Interestingly, if someone else makes a payment on behalf of the borrower, the borrower still may take the interest deduction.

INCOME SHIFTING

For some families, especially higher-income families, a child filing a tax return as an independent taxpayer (assuming they have earned income) can provide good value due to the fact that there is a better chance of qualifying for some of these tax deductions, credits and scholarships, as well as for other benefits. In the end, it can be worth the financial loss from not claiming a child as a dependent.

SCHOLARSHIPS AND TUITION

Many individuals and families from all different financial backgrounds significantly underestimate the potential scholarship and tuition discounts that their children can qualify for, particularly at private colleges. This should be an incredibly strong focus for all, including individuals and families deemed by federal financial aid formulas to not qualify for much, if any, federal need-based aid. Aggressive scholarship strategies with the appropriate student can provide value worth thousands, if not tens of thousands, of dollars, especially when accounting for college costs over four years.

Many private and some public colleges aggressively pursue the profile of students they most desire to admit. One of the best strategies you can implement is to match a child’s talents with the colleges most likely to provide school scholarships or tuition discounts. Your clients need to apply for as many scholarships as possible from a variety of different sources. It is a numbers game!

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