Take Advantage of Education Tax Benefits

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The tax code includes a number of incentives that, with proper planning, can provide tax benefits while you, your spouse, or children are being educated. Which of these options will provide the greatest tax benefit depends on each individual's particular circumstances. The following is an overview of the various possibilities.

Student Loans - A major planning issue is how to finance your children's education. Those with substantial savings simply pay the expenses as they go while others begin setting aside money far in advance of the education need, perhaps utilizing a Coverdell account or Sec. 529 plan. Others will need to borrow the funds, obtain financial aid, or be lucky enough to qualify for a scholarship. Although student loans provide one ready source of financing, the interest rates are generally higher than a home equity debt loan, which can also provide a longer repayment term and lower payments.

When choosing between a home equity loan or student loan, keep in mind the following limitations: (1) Interest on home equity debt is deductible only if you itemize, and then only on the first $100,000 of debt, and not at all to the extent that you are taxed by the alternative minimum tax; and (2) student loans must be single-purpose loans—the interest deduction is available even if you do not itemize but is limited to $2,500 per year, and the deduction phases out for joint filers with income (AGI) between $130,000 and $160,000 ($65,000 to $80,000 for unmarried taxpayers).

Gifting Low Basis Assets - Another frequently used tax strategy to finance education is to gift appreciated assets (typically stock) to a child and then allow the child to sell the stock to pay for the education. This results in transferring any gain on the stock to the child at a time when the child has little or no other income; tax on the gain is avoided or is at the child's low rate. With the lowest of the long-term capital gains rates currently being zero, Congress curtailed income shifting to children by making most full-time students under the age of 24 subject to the "kiddie tax." This effectively taxes their unearned income at their parents' tax rates and makes the gifting of appreciated assets to a child less appealing as a way to finance college expenses.

Education Credits - The tax code provides tax credits for post-secondary education tuition paid during the year for the taxpayer and dependents. Currently, there are two types of credits: the American Opportunity Credit, which is limited to any four tax years for the first four years of post-secondary education and provides up to $2,500 of credit for <u>each student</u> (some of which may be refundable), and the Lifetime Learning Credit, which provides up to $2,000 of credit for <u>each family</u> each year. The American Opportunity Credit is phased out for joint filers with incomes between $160,000 and $180,000 ($80,000 to $90,000 for single filers). The 2015 phaseout ranges for the Lifetime Learning Credit are $110,000–$130,000 for married joint and $55,000–$65,000 for others. Neither credit is allowed for married individuals who file separately. Careful planning for the timing of tuition payments can provide substantial tax benefits.

Education Savings Programs - For those who wish to establish a formalized long-term savings program to educate their children, the tax code provides two plans. The first is a Coverdell Education Savings Account, which allows the taxpayer to make $2,000 annual nondeductible contributions to the plan. The second plan is the Qualified Tuition Plan, more frequently referred to as a Sec. 529 plan, with annual nondeductible contributions generally limited to the gift tax exemption for the year ($14,000 in 2015). Both plans provide tax-free earnings if used for qualified education expenses. When choosing between a Coverdell or Sec. 529 plan, keep the following in mind: (1) Coverdell accounts can be used for kindergarten through post-secondary education and become the property of the child at age of majority, and contributions are phased out for joint filers between $190,000 and $220,000 ($95,000 and $110,000 for others) of income (AGI); and (2) Sec. 529 plans are only for post-secondary education, but the contributor retains control of the funds and there is no phase out of the contribution based on income.

Educational Savings Bond Interest—There is also an exclusion of savings bond interest for Series EE or I Bonds that were issued after 1989 and purchased by an individual over the age of 24. All or part of the interest on these bonds is exempt from tax if qualified higher education expenses are paid in the same year that the bonds are redeemed. As with other benefits, this one also has a phase-out limitation for joint filers with income between $115,750 and $145,750 ($77,200 and $92,200 for unmarried taxpayers, but those using the married filing separately status do not qualify for the exclusion). The exclusion is computed on IRS Form 8815, Exclusion of Interest from Series EE and I U.S. Savings Bonds Issued After 1989.

If you would like to learn more about these benefits, or to work out a comprehensive plan to take advantage of them, please give this office a call.