"Taxing" Circumstances: Understanding Tax Rules Regarding Your Education

When it comes to financing your graduate school education, there is a lot of important information you need to understand about tax benefits, credits, and deductions.

Let's start with two very sweet words—*tax deduction.* It makes student loan repayment a lot less frightening to know that you can deduct interest paid on your student loans when you file your annual taxes. This is courtesy of Section 221 of the Internal Revenue Code. Taxpayers who have taken out loans to pay for the cost of attending an accredited college for themselves, a spouse, or a dependent may be eligible for this deduction. The student loan tax deduction is an adjustment to income. The taxpayer enters the allowable amount on their federal income tax form to claim the deduction.

Wondering if you're qualified? To determine eligibility for this deduction, note the following criteria. A borrower must have a "qualified" student loan. Taxpayers who have obtained loans to specifically pay for the cost of attendance at an accredited college for themselves, their spouse, or dependent may deduct the amount of interest paid on their educational loan, subject to certain requirements such as an income cap.

There are many loans that qualify for this beneficial deduction. For instance, all Federal Stafford, PLUS, and Consolidation Loans qualify. Private student loans do not automatically qualify. However, if you've borrowed private loans, you're not out of luck. You can apply by sending your private loan lender a W-9S form to inquire the interest paid on your private loans would be eligible for deduction. A W-9S is an IRS form that serves as your certification that the funds were used solely for education expenses.

This is a relatively new rule, so many graduate students are not aware of it. The ability to file this deduction only began with the 2002 tax year. Before this implementation, the law only permitted deduction of the interest paid during the first 60 months of the repayment period.

So now, let's talk numbers. Students who paid interest on student loans may deduct up to $2,000 of the interest paid. This adjustment reduces the amount of taxable income, and a taxpayer may take this deduction even if he or she does not itemize deductions. Other eligible loans include those taken out to pay tuition, fees, living expenses, books, supplies, transportation, and equipment expenses. .

This deduction applies to interest paid during the first five years of repayment. Similar to education tax credits, the deduction is reduced as income increases, beginning at $40,000 for single filers and $60,000 for joint filers. If you are a single tax-return filer with an income of more than $60,000 or a joint tax-return filer with income greater than $80,000, you will not be eligible for this interest deduction.

If you're wondering how much interest *you* can deduct, you'll need to refer to your lenders. Your lenders will automatically send all eligible borrowers of FFELP loans a 1098E form stating the amount of interest paid for the

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year. If you want to include interest paid on private student loans, then you must provide your lender with a W-9S form. It is the responsibility of the taxpayer to determine how much of the stated interest is eligible for the deduction.

You can get additional information and forms by visiting www.irs.gov, researching at your local library, or by consulting your tax advisor. Always consult a tax advisor for tax advice and complete details regarding these tax provisions, as they are particular to each individuals loan. Remember: **If you do the correct research and calculations, you can make your student loan repayment work for you.**

The next tax issues deals with ***tax credits*** on undergraduate and graduate education funding.

Hope Scholarship Tax Credit: One type of benefit offered by the IRS is the Hope Scholarship Tax Credit. This tax credit may be worth up to $1,500 per eligible student for a taxpayer who paid qualified tuition and related expenses. The catch is that the Hope Scholarship Tax Credit only applies to students in their first two years of college. The eligible student must be enrolled at least half time and be working toward a degree or educational credential. This tax credit applies to students who paid for qualified expenses, including tuition and fees, but excluding room and board, books, and transportation.

The Hope Scholarship Tax Credit is designed to be reduced or phased out as the taxpayer's income increases. For a single filer, the reduction begins with income of $40,000 and the credit is eliminated at $50,000. For joint filers, the reduction begins with income of $80,000 and the credit is eliminated at $100,000. Also, the credit may only be claimed by either the student or their parent. It is a "per student" credit intended to be used by parents for dependent students or by independent students.

Lifetime Learning Tax Credit: After completing your first two years of education, you become eligible for a Lifetime Learning Tax Credit to help defray the costs of tuition and related expenses. You may claim a Lifetime Learning Tax Credit of up to $1,000 if the eligible student is enrolled in at least one course. For this type of tax credit, you do not need to be pursuing a degree. Even if you are just taking classes to improve your job skills, you may be eligible for this credit.

The Lifetime Learning Tax Credit equals 20 percent of the first $5,000 of tuition and related fees paid by the taxpayer. The reduction for this tax credit, based on income, is the same as with the Hope credit. This credit is designed as a "per return" credit. Regardless of the number of dependent students a parent claims on his or her tax return, he or she may only take one Lifetime Learning Tax Credit.

A taxpayer may take only one of the credits for each dependent student each year. For example, if a family has two children in college—one in the second year and one in the fourth year—the taxpayer may claim the Hope credit for one and the Lifetime Learning credit for the other. A taxpayer may also claim the Hope credit during the first two years of college and the Lifetime Learning credit for the remaining years.

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Important note: There is no limit to the number of years you may take the Lifetime Learning credit, so it does apply to graduate-level students as well.

Employer-Provided Student Aid: The tax code allows employees to exclude up to $5,250 of employer-provided education benefits from their taxable income. This means that employers can provide educational benefits such as tuition, fees, books, supplies, and equipment tax-free. However, this only applies to undergraduate-level courses.

Education IRAs: Education IRAs (Individual Retirement Accounts) are trusts or custodial accounts designed to help families save for a child's education. The money in these accounts grows tax-free until withdrawn. The student benefiting from an education IRA is permitted to withdraw the funds at any time. If the amount does not exceed the student's higher education expenses in a tax year—including tuition, fees, books, supplies, and room and board—the withdrawal will be tax-free.

If a student withdraws more than his or her qualified expenses for the year, a portion of the education IRA withdrawal will be taxable. The taxable amount will be considered the same as income and must be reported as earnings. The student's taxable withdrawal may also be subject to an additional 10 percent tax.

Taxpayers benefiting from a tax-free education-IRA distribution cannot take advantage of the Hope Scholarship or Lifetime Learning credit in the same year.

Taxpayers may choose to withdraw funds from a Roth IRA or traditional IRA without penalty if the funds will be used for the higher education expenses of the taxpayer, spouse, child, or even grandchild. A portion of the amount withdrawn will be taxable, but there will not be an additional 10 percent tax for an early withdrawal as long as the funds are being used for tuition, fees, books, equipment, and room and board for the year.

Student Loan Cancellation: If a borrower takes a community service job with a nonprofit, tax-exempt, charitable, or education institution that provides loan forgiveness, he or she may not need to include the cancelled amount in his or her gross income for the year. To qualify, the loan must have included a provision for this type of program; and it must have been issued by a qualified lender (such as the government, a tax-exempt public benefit corporation, or an educational institution) with the intention of helping borrowers attend educational institutions.

Conclusion

Have we changed the connation of the word *taxes* yet? It's amazing how much information and reward there is waiting for the diligent and attentive investigator. There is much to be learned concerning your graduate school educations besides the classroom material Taking advantage of the mentioned tax benefits and programs is one more way to begin saving money immediately on your education.