FINANCIAL / TAX ADVICE

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Back To School

MARCUM
TAX AND ADVISORY SERVICES

Now that summer is over, our students are heading back to school. To encourage education, especially higher education, our tax laws provide numerous incentives to parents and students alike. These incentives provide tax deductions, which reduce taxable income, credits against tax, or in some cases, tax refunds in the form of a refundable credit. In addition, there are provisions which benefit students and their parents with deductions for interest on student loans, and income exclusions for qualified tuition plans, as well as Section 529 plans. Under certain circumstances, taxpayers can access retirement funds for education without incurring penalties, and U.S. Savings Bonds redeemed with interest being excluded from income to the extent used for college expenses.

There are at least a dozen ways for taxpayers to help offset the burden of qualified educational expenses with some form of tax provision. Two of the most often used are the American Opportunity Credit and Lifetime Learning Credit. These two credits, if properly utilized, generate the biggest savings for parents and students.

American Opportunity Credit ("AOC"):

Formerly known as the Hope Scholarship Credit, the AOC provides a per student maximum credit of $2,500, which can fully offset a taxpayer's tax liability. The credit is calculated as 100% of the first $2,000 of eligible expenses, plus 25% of the next $2,000 of expenses. Eligible expenses generally include post-secondary education tuition and certain qualified expenses. The credit offsets both regular tax and alternative minimum tax and is 40% refundable. However, if the credit is claimed on a student's return, it is generally not refundable if the student is under age 24, or if certain other conditions exist.

Lifetime Learning Credit ("LLC"):

This credit is non-refundable. It is calculated at 20% of up to $10,000 of qualified tuition and fees paid during the tax year. The maximum credit is therefore $2,000. Unlike the AOC credit, which is available per student, per year, the LLC is per taxpayer, not per student. In addition, the LLC is available for non-degree courses for under-graduates, graduates, professional degree students, and students acquiring or improving job skills.

For both credits, the taxpayer who claims a dependency exemption for the student is entitled to the credit. Because each of the credits have income limitations, it is often useful for parents not to claim the student as a dependent, enabling them to secure the credit on their own tax return. To maximize the benefits of these credits, it is useful for the student to have some measure of income, which otherwise is subject to income tax, so non-refundable credits can offset their tax. Students can generate income by working at a full or part-time job, through investment income, or cashing in U.S. Savings Bonds, or selling securities from their investment portfolio. For either credit, when a third party makes a payment directly to an eligible educational institution for qualified education expenses, for purposes of calculating the credit, the student is treated as having received the payment and in turn paying the qualified expenses. Therefore, even if the student is not making a direct payment for their own expenses, they might still be eligible for the credit.

The AOC is generally a more beneficial credit than the LLC. Each situation must be reviewed to determine which credit provides the most benefit.

As with all tax provisions, there are many nuances and planning opportunities. For more information, you can secure Publication 970, Tax Benefits for Education available on the Internal Revenue Service website. This Publication addresses the entire range of tax savings opportunities for parents and students related to education.

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