EDUCATIONAL BENEFITS GROUP

Providing solutions to make college an affordable reality

Education Tax Incentives

Table of Contents

EDUCATION TAX INCENTIVES

Education Tax Incentives

As of 2004, there are now eight major education tax incentive programs:

1. Student Loan Interest Deduction,
2. Employer Education Assistance Plans (Section 127),
3. IRA Withdrawals (for education),
4. Hope Tax Credit,
5. The Lifetime Learning Credit,
6. College Tuition Deduction,
7. Educational IRA (now called the Coverdell Educational Savings Account),
8. Qualified Tuition Programs (529 plans),

One of the more perplexing aspects of these educational incentives is how they all function together. An aspect of the new law that will not be appreciated by many taxpayers is its complexity. The IRS also faces a formidable task in developing the necessary guidance for taxpayers and their professional advisers.

The IRS will require that you document and keep track of the college expenses. You will now need to know what is the cost of attendance at the college, what are the qualified expenses of the college, document where the money came from that paid the expenses and how the bill was paid. Every family will need to know the definition of educational qualified expenses as it applies to each college.

Not only is the new tax law confusing from a federal tax standpoint, but also many families with college bound students will find the complexity could be almost intolerable. In this book will focus on some of the new federal tax laws, tax treatment of scholarship and the complexity that will exist for families of all income levels.

Tax Status of Scholarships

Many years ago scholarships or fellowships were generally tax-free to students. Today, the tax rules aren't so simple or generous. The rules governing the tax treatment of scholarships and fellowships became more complicated more than a decade ago. The IRS suspects that many students still don't realize that the Tax Reform Act of 1986 made more types of scholarship and fellowship income subject to tax. The tax treatment now depends on whether you're pursuing a degree and what you use the money for.

If you're seeking a degree, scholarship funds used to pay tuition, fees, books, supplies and equipment are tax-exempt. But amounts covering other expenses, such as room and board, are subject to tax. Also taxable are payments for teaching, research or other services required as a condition of receiving the grant.

If you're not seeking a degree, all of your scholarship and fellowship income is taxable.

Computer & Equipment Restrictions

The IRS places tough restrictions on the types of school supplies that can be purchased with tax-exempt scholarship funds. The tax break is allowed only for books, supplies and equipment that are required of all students in that course. It's not enough that the professor suggests that some piece of equipment, such as a computer, might be ***helpful*** to students taking the course. <u>It must be a mandatory purchase for all students taking the class</u>.

For example, say you received a scholarship to take a writing course at a university and the instructor suggests that it would be helpful for students to have a personal computer in their dorm room to work on assignments. Scholarship money used to buy the computer wouldn't be tax-exempt since buying a word processor was only a recommended purchase and not a requirement for anyone taking the course.

A ***scholarship*** is generally an amount paid for the benefit of a student at an educational institution to aid in the pursuit of studies. The student may be either an undergraduate or graduate.

A ***fellowship*** is generally an amount paid for the benefit of an individual to aid in the pursuit of study or research.

Candidate for a degree. The term "candidate for a degree" means a student (full or part-time) who:

1. Attends a primary or secondary school or is pursuing a degree at a college or university, or
2. Attends an accredited ***educational institution*** that is authorized to provide:
    a. A program that is acceptable for full credit toward a bachelor's or higher degree or,
    b. A program of training to prepare students for gainful employment in a recognized occupation.

Educational institution. An educational institution 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 scholarship or fellowship. A qualified scholarship or fellowship is any amount you receive as a scholarship or fellowship grant that is used under the terms of the grant for:

- Tuition and fees paid to enroll in, or to attend, an educational institution, or
- Fees, books, supplies, and equipment that are required for the courses at the educational institution. These items must be required of ***all*** students in your course of instruction.

Your scholarship or fellowship grant can still qualify as tax free even if the terms do not provide that it be used only for tuition and course-related expenses.

It will qualify if you use the grant proceeds for tuition and course-related expenses. However, if the terms of the grant require its use for other purposes, such as room and board, or specify that the grant cannot be used for tuition or course-related expenses, the amounts received under the grant are not tax free.

Athletic scholarships. Athletic scholarships are tax free if they meet the requirements discussed above.

Fulbright grants. A Fulbright grant is generally treated as any other scholarship or fellowship in figuring how much of the grant is tax-free. If you receive a Fulbright grant for lecturing or teaching, it is payment for services and is taxable. A special rule applies if the grant was paid in nonconvertible foreign currency.

A Fulbright grant is a grant under the Mutual Educational and Cultural Exchange Act of 1961, known as the Fulbright-Hays Act. If you receive a supplemental grant under the U.S. Information and Educational Exchange Act of 1948 (Smith-Mundt Act) for study, research, or teaching abroad, it is treated like a Fulbright grant.

Pell Grants, Supplemental Educational Opportunity Grants, and Grants to States for State Student Incentives. These grants are tax free if they are used for qualifying tuition and course-related expenses during the grant period.

Veterans' benefits. Payments you receive for education, training, or subsistence under any law administered by the Department of Veterans Affairs (VA) is tax-free. But you may have to reduce your deduction for educational expenses by the amount of these tax-free payments. For more information, see IRS Publication 508.

Deductible educational expenses. If your scholarship or fellowship grant is tax free, you must reduce your deductible educational expenses by the amount of the grant you receive for those expenses.

Your educational expenses, such as tuition, fees, books, and supplies, are ordinarily deductible if they are used to maintain or improve skills in your present work, or to retain your job or rate of pay. Once again, see IRS Publication 508 for more information.

Taxable Scholarships and Fellowships

If your scholarship or fellowship does not meet the rules described earlier, it is taxable. The following are examples of amounts that are taxable.

Incidental expenses. An amount you receive for incidental expenses is not a tax-free qualified scholarship. Incidental expenses are expenses for items that are not required for either enrollment or attendance at an educational institution, or in a course of instruction at the educational institution. Incidental expenses include:

- Room and board,
- Travel,
- Research,
- Clerical help, and
- Equipment.

Example. You receive a scholarship from State University to enroll in a writing course. Suggested supplies for the writing course include a word processor. Amounts used for suggested supplies are not qualified scholarship expenses. You cannot include the cost of a word processor to determine the amount received as a qualified scholarship.

Payment for services. You must include in income the part of any scholarship, fellowship, or tuition reduction that represents payment for past, present, or future teaching, research, or other services. This applies even if all candidates for a degree must perform the services to receive the degree.

Example 1. You received a scholarship of $2,500. As a condition for receiving the scholarship, you must serve as a part-time teaching assistant. Of the $2,500 scholarship, $1,000 represents payment for teaching. The grantor gives you a Form W-2 showing $1,000 as income. You used all the money for tuition and course-related expenses. Assuming that all other conditions are met, $1,500 of your grant is tax-free. The $1,000 you received for teaching is taxable.

Example 2. You are a candidate for a degree at a medical school. You receive a government grant for your medical education and training. The terms of the grant require you to perform a period of obligated service in a designated medically underserved area of the country following completion of your medical studies. A substantial penalty applies if you do not comply. The entire amount of your grant is taxable as payment for services in the year it is received.

Payments to service academy cadets. An appointment to a United States military academy is not a scholarship or fellowship. Payment you receive as a cadet or midshipman at an armed services academy is pay for personal services. Include this pay in your income in the year you receive it.

Scholarship prizes. Cash scholarship prizes won in a contest are not considered scholarships, if you do not have to use the prizes for educational purposes. Non-education prizes are taxable regardless of how you use the money.

Additional Information: If there is some doubt about the tax treatment of your grant, consult the grantor. The grantor may have received advice from the IRS about the appropriate tax treatment of the grant. You can also contact the District Director of Internal Revenue for the district in which you live. Be sure to ask for the information as soon as possible so that you can receive an answer in time to file your return. If you request this advice by mail, give a complete statement of all the facts.

Reporting Scholarships and Fellowships

If your only income is a tax-free scholarship or fellowship, you do not have to file a tax return and no reporting is necessary. If all, or part, of your scholarship or fellowship is taxable and you are required to file a tax return, you should report the taxable amount. You must report the taxable amount regardless of whether you received a Form W-2.

Form 1040EZ. Include on line 1 the taxable amount not reported on Form W-2. Print "SCH" and the amount not reported to the right of the words "W-2 form(s)" on line 1.

Form 1040 or 1040A. Include the taxable amount not reported on Form W-2 on line 7. Print "SCH" and the amount not reported on the dotted line next to line 7 on Form 1040 or in the space to the left of line 7 on Form 1040A.

Schedule SE (Form 1040). Amounts you receive under a grant that represent pay for your services as an independent contractor are included in determining net earnings from self-employment. If your net earnings are $400 or more, you will have to pay self-employment tax. Use Schedule SE to figure this tax. Whether you are an independent contractor or employee depends on the facts in your situation. The general rule is that you are an independent contractor if the payer has the right to control or direct only the result of the work and not what will be done and how it will be done.

You are not an independent contractor if you perform services that can be controlled by an employer (what will be done and how it will be done). This applies even if you are given freedom of action. What matters is that the employer has the legal right to control the details of how the services are performed. If an employer-employee relationship exists (no matter what the relationship is called), you are not an independent contractor.

For more information in determining whether you are an independent contractor or an employee, get IRS Publication 15-A, *Employer's Supplemental Tax Guide*.

STUDENT LOAN INTEREST DEDUCTION

These deductions can save hundreds of dollars a year in taxes, but the eligibility rules are restrictive, despite the new law changes

The student loan deduction offers the opportunity to write off each year up to $2,500 of interest paid on a loan used to pay college expenses of the taxpayer, the taxpayer's spouse or dependent. The deduction can be claimed regardless of whether you itemize your deductions. That's a big help to recent college grads who are paying off student loans and who usually don't have enough deductible expenses to itemize. But the deduction carries numerous restrictions, although a couple of them will be eased by a provision in the Tax Relief Act of 2001.

New Law Eases Some Restrictions

One restriction that was eased is the time limit on the deduction. This time 60-month time limit was eliminated as of Jan. 1, 2002, which should be of great help to college grads who take many years to pay off their college debts.

In 2004, the income phase-out ranges to $50,000 to $65,000 for single taxpayers and to $100,000 to $130,000 on joint returns.

Some Tough Restrictions Remain

Parents below the income cut-offs who take out a loan to pay a dependent child's college expenses can deduct the interest – provided the loan is used solely to pay college expenses. Mixed-use loans aren't deductible.

But parents can't deduct interest on a student loan taken out by their child – even if the parents are the ones paying off the loan. Only the person legally liable for the loan payments can claim the deduction.

In a catch-22, the child who took out the student loan won't be eligible to deduct the interest, either, if he or she is claimed as a dependent on the parent's return. Children, however, can begin deducting interest payments on their student loans once they're no longer claimed as dependents.

Home-Equity Loans

Homeowners who are using a home-equity loan to finance a college education will be able to deduct the interest, but only as a mortgage interest deduction on Schedule A. Even though some people would come out ahead using the student loan deduction, the tax law doesn't give taxpayers the option. The tax law prohibits student loan deductions for interest, such as home-mortgage interest, that is allowed to be deducted elsewhere on the tax return.

Tax Help For College Expenses: An Overview

For most college students and their parents, the Hope Scholarship and Lifetime Learning tuition credits created by the Taxpayer Relief Act of 1997 will be the most valuable tax benefits available to help defray college costs. But there are some other tax breaks – both new and old – that may provide help with college costs.

Job-Related Courses

If you're a worker taking college courses directly related to your current job, many of the costs of the education could be deducted.

The ability to deduct the costs will be particularly helpful to workers who aren't eligible to write off some or any of their college expenses under the tuition credits or the new college tax deduction, which are subject to income-eligibility requirements and other limitations.

To qualify for the worker education deductions, the courses must help you maintain or improve skills for your present job. Or the courses must be required by your employer or by law to keep your present job, position or salary.

EMPLOYER EDUCATIONAL ASSISTANCE PROGRAMS (Section 127)

Employers can sometimes be a rich source of financial aid for workers. Several thousand companies offer tuition assistance programs as a fringe benefit for employees who want to further their college studies. The tax treatment of these Employer Educational Assistance Programs (Section127) is also generous. Up to $5,250 a year of tuition assistance is tax-free to the employee. Beginning in 2002, the Tax Relief Act of 2001 will extend the exemption to graduate-level studies. Prior to 2002, only undergraduate courses qualified.

College Employees

Many college employees and their families also get financial help from their employer. A valuable perk commonly offered by universities gives college employees and their dependents a chance to take college courses for free or at discounted tuition rates.

The tax treatment is also generous. The tuition benefit is generally considered a tax-free fringe benefit when used for undergraduate studies by university employees, their spouses or their dependent children.

The tax-free treatment applies to graduate-level studies only for teaching and research assistants, but not their family members.

IRA WITHDRAWALS

Another source of cash for college expenses is Individual Retirement Accounts. Thanks to the 1997 tax act, IRA withdrawals are no longer subject to "early withdrawal" penalties if the money is used to pay college expenses. (With few exceptions, IRA withdrawals made before age 59 1/2 are subject to a 10 percent penalty.) The penalty-free withdrawals can be made from the student's IRA or from the IRA of a spouse, parent or grandparent.

Expenses eligible for IRA withdrawals include tuition, fees, books, supplies and equipment. Certain room and board expenses are also eligible if the student is enrolled on at least a half-time basis.

HOPE SCHOLARSHIP CREDIT (HC)

The HC is a non-refundable credit against an individual's federal income tax liability. The HC is calculated by taking 100% of the first $1,000 of "qualified tuition and related expenses" plus 50% of the excess of these expenses up to a $1,000 limit.

> ***EXAMPLE***: If the qualified expenses of an individual student were $2,000, the HC would be $1,500 (100% x $1,000 plus 50% x $1,000). If the expenses were only $1,600, the HC would be $1,300 (100% x $1,000 plus 50% x $600).

The maximum HC allowed per student is $1,500 per year. The credit can be claimed for each student claimed on the tax return. For example, if there are two "eligible students" that have qualified expenses, a maximum HC of $3,000 (2 students x $1,500) can be claimed.

The HC is phased out when the taxpayer reaches certain levels of "Modified Adjusted Gross Income". The credit is ratably phased out for Modified AGI of between $42,000 to $52,000 for single or head of household taxpayers and $85,000 to $105,000 for married taxpayers.

The HC is only available for certain qualified expenses for undergraduate courses at "eligible educational institutions". Qualified expenses are tuition and related fees at these eligible educational institutions, and do not include books, room and board, personal transportation or living expenses, activity fees, or insurance. The qualified expenses have to actually be paid during the academic period or within three months after the beginning of the academic period. For example, a taxpayer that pays qualified expenses, during the calendar year of 2004 for an academic period that begins in January, February, or March of 2005, will qualify for the HC in 2004. Qualified expenses paid with the proceeds of a loan would be eligible for the HC.

The qualified expenses are reduced by tax-free grants or scholarships (IRC Sec. 117), employer provided educational assistance (IRC Sec. 127), veterans education benefits (IRC Sec. 134), and qualified expenses deducted elsewhere on the tax return (e.g., Schedule A, C, or F).

NOTE: The tax law does not specify that payment for tuition and fees must be ordered in a specific way. Current Treasury Department advice is that schools must determine how funds will be applied to students' accounts.

To qualify for the HC the student must be attending an eligible educational institution. The institution must be a post-secondary institution, not a high school institution. The institution must meet the criteria defined in Section 481 of the 1965 Higher Education Act and, therefore qualify to participate in the student aid programs administered by the Department of Education. This would include virtually all accredited public, nonprofit, and proprietary postsecondary institutions.

The HC cannot be claimed in the same year that a tax-free distribution from an Education IRA (CESA) is received. However, if the CESA distribution is elected to be taxable, the HC can be claimed. The HC cannot be claimed for the same qualified expenses for which the Lifetime Learning Credit (LC) is claimed. The HC can be claimed in the same year as the student receives a distribution from a "qualified state tuition program".

LIFETIME LEARNING CREDIT (LLC)

The LLC is a non-refundable credit against the individual's federal income tax liability. The LLC is calculated by taking 20% of up to a maximum of $10,000 in "qualified tuition and related expenses"; the limit for the LLC is $2,000 per taxpayer tax return.

> ***EXAMPLE***: If a family has a combined total of $10,000 in qualified expenses for all the exemptions claimed on the tax return, the LLC for the tax return would be $2,000, 20% x $10,000 maximum qualified expenses. If the same family only had combined expenses of $8,000, the LLC would be $1,600, (20% x $8,000).

The maximum LLC allowed per taxpayer return is $2,000 per year and the credit can be claimed for multiple students on the same tax return.

> ***EXAMPLE***: If there are two eligible students that each has qualified expenses of $10,000, the maximum LLC that could be claimed is $2,000 per that taxpayer return.

The LLC is phased out when the taxpayer reaches certain levels of "Modified Adjusted Gross Income". The credit is ratably phased out for Modified AGI of between $42,000 to $52,000 for single or head of household taxpayers and $85,000 to $105,000 for married taxpayers.

The LLC is only available for certain qualified expenses for undergraduate courses at "eligible educational institutions". Qualified expenses are tuition and related fees at these eligible educational institutions, and do not include books, room and board, personal transportation or living expenses, activity fees, or insurance. The qualified expenses have to actually be paid during the academic period or within three months after the beginning of the academic period. For example, a taxpayer that pays qualified expenses, during the calendar year of 2004 for an academic period that begins in January, February, or March of 2005, will qualify for the HC in 2004. Qualified expenses paid with the proceeds of a loan would be eligible for the HC.

The qualified expenses are reduced by tax-free grants or scholarships (IRC Sec. 117), employer provided educational assistance (IRC Sec. 127), veterans education benefits (IRC Sec. 134), and qualified expenses deducted elsewhere on the tax return (e.g., Schedule A, C, or F).

NOTE: The tax law does not specify that payment for tuition and fees must be ordered in a specific way. Current Treasury Department advice is that schools must determine how funds will be applied to students' accounts.

To qualify for the LLC the student must be attending an eligible educational institution. The institution must be a post-secondary institution, not a high school institution. The institution must meet the criteria defined in Section 481 of the 1965 Higher Education Act and, therefore qualify to participate in the student aid programs administered by the Department of Education. This would include virtually all accredited public, nonprofit, and proprietary postsecondary institutions.

The LLC cannot be claimed in the same year that a tax-free distribution from an Education IRA (CESA) is received. However, if the CESA distribution is elected to be taxable, the HC can be claimed. The LLC cannot be claimed for the same qualified expenses for which the Lifetime Learning Credit (LC) is claimed. The LLC can be claimed in the same year as the student receives a distribution from a "qualified state tuition program".

THE COLLEGE TUITION DEDUCTION

A New Alternative to Hope and Lifetime Tuition Credits

The new tax law creates a new – albeit temporary – tax deduction for college tuition that could be claimed in lieu of the Hope Scholarship or Lifetime Learning tax credits. The new college tuition deduction could help taxpayers with incomes too high to get much, if any, benefit from the Hope or Lifetime credit.

Amounts Vary by Year and Income

In 2004 and 2005, taxpayers with adjusted gross incomes up to $65,000 ($130,000 on joint returns) will be eligible for a maximum deduction of $4,000 per year.

New College Tax Deduction

Income Eligibility Adjusted Gross Income		Maximum Deduction			
Unmarried	**Joint Return**	**2002**	**2003**	**2004**	**2005**
Up to $65,000	Up to $130,000	$3,000	$3,000	$4,000	$4,000
$65,001 to $80,000	$130,001 to $160,000	0	0	$2,000	$2,000

Taxpayers with incomes up to $80,000 ($160,000 on joint returns) could deduct up to $2,000.

The deduction is scheduled to lapse after 2005. The deduction can be claimed regardless of whether you itemize your deductions.

As with the Hope and Lifetime credits, the new college tuition deduction is available for tuition and fees paid for the education of the taxpayer, the taxpayer's spouse or a dependent child.

You will have to choose between using this approach and taking the existing Hope and Lifetime Learning credits. This could be the more beneficial avenue, but those eligible will have to figure their taxes twice to determine that.

You will have to make a choice. Taxpayers won't be eligible to claim the new deduction and a Hope or Lifetime Learning credit in the same year with respect to the same student.

Caution When Comparing Benefits

When comparing the tax breaks, keep in mind that a tax credit is much different from a deduction. A tax credit offsets your tax liability dollar for dollar, while a deduction provides only a partial offset.

The Hope credit of up to $1,500 can save you up to $1,500 in taxes. The Lifetime credit of up to $2,000 can save you up to $2,000 in taxes. By comparison a $3,000 deduction would save $810 in taxes if you were in the 28 percent tax bracket and $450 if you're in the 15 percent tax bracket. When making comparisons, also keep in mind the special formulas for calculating the Hope and Lifetime credits. Also be aware that IRS regulations provide a way for households with incomes above the eligibility limits to still take advantage of the Hope and Lifetime credits.

This is accomplished by shifting the tax credits to the student. To benefit from the approach, the student must have a tax liability to the IRS and the student **MUST** show that they provided more than 50% of their own support. The student must also claim themselves (as a personal exemption) on their own tax return.

COVERDELL EDUCATION SAVINGS ACCOUNTS

The new law will greatly expand education IRAs beginning in 2002. In one of the most controversial changes made by the legislation, the new law will allow education IRAs to be used for elementary and secondary-school expenses, including tuition at private and parochial schools.

Education IRAs Renamed "Coverdell Education Savings Accounts

The Coverdell Education Savings Account’s (CESA) annual contribution limit is $2,000 and distributions can now also be used for private elementary and secondary school costs.

Contributions to a CESA can be made on behalf of a child under age 18. Contributions aren't deductible but withdrawals can be made tax-free if used to pay eligible education expenses.

Income-Eligibility Limits

The new law will also raise the income-eligibility limits for married couples. Under the new law, the phase-out range for couples will be $190,000 to $220,000. For single individuals, eligibility phases out between adjusted gross incomes of $95,000 and $110,000 – the same as in the past.

Multiple Benefits

Families who take advantage of CESAs are no longer automatically disqualified from also claiming the Hope or Lifetime college tuition credit for a student in some years. Prior to 2002, the tuition credits couldn't be claimed for a student in those years when money is withdrawn from the student's CESA. But the new law will remove the prohibition so long as the CESA withdrawals aren't used for the same expenses for which the Hope or Lifetime credit is claimed.

Contribution Deadline

The deadline for making annual contributions to education IRAs will be extended. Instead of having to contribute by Dec. 31 each year, the new law will allow contributions to be made as late as April 15 of the following year. That is the same deadline for contributions to other types of IRAs. Extending the deadline to April 15 will be of particular help to higher-income families who aren't sure until they fill out their tax returns whether they meet the income-eligibility requirements for the CESA.

Contentious Issue

Expanding CESAs was a top priority of Congressional Republican in recent years.
Expanding the tax-sheltered accounts to pre-college expenses was part of an effort to advance the conservative cause of "school choice."

Eligible Elementary and High School Expenses

CESA funds can be used for a wide variety of elementary and high school expenses. Included are tuition, fees, academic tutoring, books, supplies, equipment and "special needs services" for special needs students. Also eligible expenses for kindergarten through 12th grade students are room, board, uniforms, transportation and "supplementary items and services (including extended day programs) which are required or provided by a public, private or religious school in connection with such enrollment or attendance."

Computers and Internet Access: CESAs can also be used as a tax-sheltered way to save for a computer system for a child. Computers, peripheral equipment, software and Internet access are made eligible education IRA expenses for elementary and secondary school children.

However, CESA funds cannot be used for "computer software designed for sports, games or hobbies unless the software is predominantly educational in nature. It is unprecedented new ground gained for elementary and secondary school children in making home computers more affordable. The new addition to the law is intended to reduce taxes so that parents could more easily purchase computers, Internet access, and educational software for their K-12 children.

The Financial Aid Trap

Lower- and middle-income parents who expect their child will be eligible for financial aid in college should think twice about taking advantage of CESAs for college savings. Despite the tax advantages, you could end up losing more in financial aid than you'll save in taxes. That's because a CESA must be set up in the child's name. In determining how much a family can afford to contribute to the cost of college, financial aid formulas count assets held in a child's name much more heavily than assets in the parent's name. However, if the only aid the student will qualify for are loans then the educational IRA would make sense. CESAs can be very attractive for higher-income families who don't expect to be eligible for financial aid. The ability to make contributions phases out for couples with adjusted gross incomes between $190,000 and $220,000 on a joint return ($95,000 to $110,000 for unmarried individuals.)

QUALIFIED TUITION PLANS (529 Plans)

Another investment alternative that allows significant amounts to accumulate in a tax-deferred manner until withdrawn for post-secondary education is the Qualified Tuition Program (QTP) or Sec. 529 plan. If withdrawals from 529 plans are used for qualified higher education expenses they are excluded from federal income taxes.

Qualified withdrawals from QTPs became tax-free as a result of the 2001 Economic Growth and Tax Relief Recovery Act (EGTRRA). All changes made by EGTRRA are scheduled to expire or "sunset" at the end of 2010. Unless the Sec. 529 provisions are extended, qualified withdrawals from a QTP after 2010 will not be tax-free. Withdrawn earnings beginning in 2011 will be reported by the designated beneficiary as ordinary income.

Types of QTPs

Sec. 529 describes a QTP as a program established and maintained by a state under which persons may:

1. Purchase tuition credits or certificates on behalf of a designated beneficiary that entitle the beneficiary to a waiver or payment of <u>qualified higher education expenses</u> of the beneficiary, or

2. Make contributions to an account that is established for the sole purpose of meeting qualified higher education expenses of the designated beneficiary of the account.

Definition of Qualified Expenses and Eligible Institutions

The term "qualified higher education expenses" generally includes tuition, fees, books, supplies, and equipment required for enrollment or attendance of the designated beneficiary at an eligible educational institution.

Account owner

The account owner continues to control all aspects of the QTP account, including the timing and use of withdrawals. The beneficiary typically has no ownership rights, unlike custodial accounts, irrevocable trusts, and Coverdell ESAs. Many QTPs accept contributions to the account from donors other than the account owner.

Sec. 529 does not require that the account owner be a natural person. Depending on the particular QTP, a corporation, partnership, trust, or other entity may be able to establish an account for a beneficiary. The requirement that a beneficiary be named to the account is waived, if a state or local government or a 501(c) (3) organization as part of a scholarship program establishes an account.

Designated Beneficiary

The designated beneficiary must be a living individual but does not have to be related to the donor. In most QTPs the donor can establish an account naming himself as designated beneficiary. The account owner may replace the beneficiary with a new beneficiary who is a member of the family of the old beneficiary. The definition of member of the family includes the beneficiary's descendants, ancestors, brothers and sisters, aunts, uncles, nephews, nieces, certain in-laws, and first cousins.

Contributions

There are no annual contribution limits under federal law. However, each state may have ceilings on their own maximum contribution levels. In addition, there are no income restrictions or age restrictions on either the donor or the beneficiary.

Gift, Estate, and Generation-Skipping Transfer Tax

A contribution to a QTP is treated as a completed gift of a present interest from the donor to the designated beneficiary. The contribution qualifies for the $11,000 annual gift tax exclusion. The amount excluded from gift tax is also excluded for purposes of the generation-skipping transfer tax. The value of the account is not included in the account owner's gross estate. The IRS has indicated that the account is included in the estate of the designated beneficiary.

Distributions

Earnings on contributions are distributed tax free provided the beneficiary has incurred qualified education expenses equal to or exceeding the amount of distributions during the year.

- Distributions are deemed to have been paid pro-rata from contributions, which are always tax-free, and earnings, which are excludible if used for qualified education expenses.

- The QTP will report gross distributions and the earnings portion to the distributee on Form 1099Q. The distributee (account owner or beneficiary) is responsible for computing the amount of exclusion when filing Form 1040.

If the beneficiary's qualified education expenses are less than distributions received from a QTP, a portion of the distributed earnings will not be excluded from income. To determine the amount excludable, the earnings portion of distributions must be multiplied by a fraction, qualified education expenses divided by total distributions during the year. Any distributed earnings that are not excluded under that formula must be reported as ordinary income by the beneficiary.

Rollovers

A rollover distribution will not be treated as a distribution for federal income tax purposes. A rollover can be transacted through a direct transfer between programs or through a distribution followed be re-contribution to another QTP within 60 days. Most (but not all) states will follow federal treatment for purposes of state-imposed refund penalties (if any) and state income tax. A same-beneficiary rollover may be transacted only once in a 12-month period. A rollover involving a change of beneficiary to another member of the original beneficiary's family may be transacted at any time. The state receiving a rollover must reduce the tax basis of the account by the amount of untaxed earnings in the rollover distribution. QTPs are required to provide the information needed to make this adjustment.