

Education tax relief no easy pickings. You might need a degree just to grasp what works for you

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Taxpayers trying to pay for college are in for a windfall from the \$1.35 trillion tax cut Congress just passed. But figuring out how to take advantage of the new tax breaks won't be easy. "Some of this will really make your head spin," says Joe Hurley, CEO of SavingForCollege.com. Deciphering the key provisions of the act, which President Bush is expected to sign next week:

Education Savings Account

In 2002, the new Tax Relief Act transforms the puny Education IRA into a powerful savings tool. Initiated by Congress in 1997, the Education IRA mimics the benefits the Roth IRA offers for retirement. Contributions are made with after-tax money, with tax-free withdrawals for education expenses.

But the Education IRA -- with its stingy \$500 limit on contributions each year -- has failed to catch on. Tax-free withdrawals are forbidden in the same year that a taxpayer claims either of two lucrative credits for college expenditures -- the Hope Scholarship Credit or the Lifetime Learning Credit.

Hope permits a reduction in taxes up to \$1,500 per student for first- or second-year college expenses. Lifetime Learning provides a tax reduction of up to \$1,000 per qualifying family per year for college costs after that.

"In most cases, it's been a no-brainer to take the credits," says Kalman Chany, author of *Paying for College Without Going Broke*. But the limitations vanish in January, when the newly renamed Education Savings Account takes effect. Among the changes:

- The annual contribution limit increases to \$2,000 per student.
- Benefits become available to more taxpayers as the maximum allowable adjusted gross income for married filers increases to \$220,000 from \$160,000.
- Education expenses that qualify for tax-free withdrawals are expanded to include not only colleges, but kindergarten through 12th grade, too.

Kathy Burlison, tax analyst at H&R Block, says new qualifying expenses for K-12 are broader than just the tuition, fees and room-and-board allowed for higher education. Parents of younger students also may spend for such things as uniforms, transportation, extended day care -- even home computers.

State-sponsored 529 plans

The new tax law will make state-sponsored 529 college savings plans more flexible and generous. The plans let parents, relatives and friends invest for a child's college education. Under current law, the after-tax contributions grow tax-deferred until they are withdrawn. The funds, which can be used for tuition, fees, books, room or board, are taxed at the student's rate. Many states offer 529 plans. They caught on in part because there are no income restrictions on contributors. And they let you invest more than \$100,000 per child. The plans can be switched to another child if the first beneficiary decides not to go to college.

The downside: If you need the money for a non-education purpose, you'll get hit with a 10% federal tax penalty, ordinary income tax and, in some cases, another penalty from the state. And some experts say the plans can have high fees and don't offer enough investment control. "There is such a limitation in choices of investments," says Lydia Sheckels, a financial planner in Philadelphia. "You give up a lot just to get a preferred tax vehicle, hoping your child will go to college and Congress doesn't change the tax law."

The new tax law will make significant improvements in 529 plans:

- Next year, withdrawals for college expenses will be entirely tax-free.
- You will be able to switch to another state plan once every 12 months without changing the beneficiary. Under current law, it's difficult to shift.
- The new law will allow beneficiary switching among cousins, as well as among members of an immediate family, a boon to generous grandparents.

Higher education deduction

The law will create a federal deduction for college expenses, which could benefit parents who don't qualify for the Hope or Lifetime Learning credits.

The maximum annual deduction in 2002 and 2003 is \$3,000 for single taxpayers with adjusted gross incomes of \$65,000 or less and joint filers with AGIs of \$130,000 or less. In 2004 and 2005, the deduction increases to \$4,000.

There also is a provision for higher-income taxpayers to take a \$2,000 tuition deduction in 2004 and 2005 only.

Single taxpayers with adjusted gross incomes over \$65,000 but not more than \$80,000 and joint filers with incomes over \$130,000 but not more than \$165,000 qualify.

To minimize the federal budget drain, the new deduction expires in 2006.

Another provision of the new law will help parents and students in the process of repaying school loans by making more of the interest deductible.

Coordinating tax breaks

Once you understand the education provisions, you have to figure out how to make the most of them.

The new law will erase the ban on taking a tax-free withdrawal from a 529 plan or an Education Savings Account in the same year you claim a Hope or Lifetime Learning credit. But dealing with both on the same tax return will be tricky: School expenses covered by tax-free earnings cannot then be claimed for a Hope or Lifetime Learning credit.

Such fine distinctions indicate Congress has done nothing to simplify the education-related parts of the tax law.

Says Chany: "Figuring out where to get the most goodies used to take a master's degree. Now you need a Ph.D."

The new law will not allow you to claim a tuition deduction and a Hope or Lifetime Learning credit in the same year for the same student. Parents who qualify for all of them may find that the deduction is more advantageous if their taxable income is above the 15% tax bracket, tax experts say.

Here's an example from tax experts at Deloitte & Touche: If a family with taxable income of \$40,000 in 2002 spends \$5,000 on qualified higher-education expenses, it would make more sense for them to take a \$1,000 Lifetime Learning Credit, than a \$3,000 deduction. The credit would cut their taxes by \$1,000. The deduction would produce only \$450 in tax savings. If the same family also had an Education Savings Account or a 529 plan, it could use those tax-free funds to pay for the remaining \$4,000 in expenses.

Selecting the best college savings option isn't easy. But don't let confusion paralyze you. The important thing is to start saving regularly, experts say.

Ron McElhaney Jr., an executive recruiter in Savannah, Ga., says he's been considering 529 plan accounts for his two children, 5 and 2. But he's concerned about the limited number of investment options and the management fees. In the meantime, he's simply setting aside money for college in a separate account. "I'm watching 529 plans," he says. "The new changes will definitely make me take a closer look."

Tim Lane, director of college finance at TIAA-CREF, says some 529 plans provide generous state income tax breaks. In high-tax states like New York, he says, state tax benefits are often enough to tip a decision away from an Education Savings Account in favor of a 529 plan. Families that live paycheck to paycheck can't afford to set aside cash for college that can't be accessed in case of emergency. "They need a fund that's multipurpose," Sheckels says.

Those who can afford to lock up money for college tend to opt for a 529 plan because there are no income limits. But Education Savings Accounts have the edge on at least two counts:

- **Flexibility.** Education Savings Accounts provide total freedom to direct investments.
- **Certainty.** Although chances are good that Congress will revisit the issue in coming years, the Tax Relief Act expires in 2011. If that happens, withdrawals from a 529 plan would once again become taxable to the student who gets the benefits. Withdrawals from an Education Savings Account (or the old Education IRA), have never been taxable, so expiration of the law in 2011 would not change the tax exemption for withdrawals.