Focus
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The Practitioner Tax Law

Learning Incentive

New Law Changes Treatment of Educational Expenses

By Boyd D. Hudson and Louis E. Michelson

On June 7, President George W. Bush signed into law the Economic Growth and Tax Relief Reconciliation Act of 2001. The provisions of the act that received the most headlines were the across-the-board reductions in individual tax rates and the phase-out of the estate tax. What did not receive much notice were the provisions designed to assist parents and individuals in financing post-secondary education. These provisions constitute an acknowledgment of the education-funding crisis and a recognition that the government can help through tax incentives. Unless otherwise noted, these changes are effective for years beginning after Dec. 31.

■ **Deduction for higher-education expenses.** Under current law, an individual generally is not permitted to deduct amounts paid for education and training expenses. However, a deduction is allowed if the education maintains or improves a skill required in a trade or business of the taxpayer or if it meets requirements of the taxpayer's employer. Treas. Reg. Section 1.162-5. Taxpayers who cannot prove a business need for the education expense are thus denied a deduction.

Even if the expense is business-related, education expenses are not deductible if they relate to certain minimum educational requirements that allow a taxpayer to pursue a new trade or business. Treas. Reg. Section 1.162-5(b)(3). For example, an accountant cannot deduct the cost of attending law school as a business expense because the law training qualifies him for a new occupation. Treas. Reg. Section 1.1625(b)(3)(ii), ex.(1)

Under current law, low- and middle-income taxpayers are eligible for two separate credits for tuition expenses incurred by students pursuing college or graduate degrees or vocational training. Internal Revenue Code Section 25A. Credits offset income tax on a dollar-for-dollar basis.

The HOPE scholarship credit provides a maximum allowable credit of $1,500 per student for each of the first two years of post-secondary education. Section 25A(b). The Lifetime Learning Credit allows a credit of 20 percent of qualified tuition expenses paid by the taxpayer for any year the HOPE credit is not claimed. Section 25A(c). The maximum credit per taxpayer return is $1,000 until 2003, but this amount then rises to $2,000 for years starting after Dec. 31, 2002.

One problem with both credits is that they phase out at very low income levels. For single taxpayers, the credits phase out beginning at $40,000 of modified adjusted gross income and are unavailable at $50,000 of adjusted gross income and higher. For married taxpayers filing a joint return, the ranges are $80,000 to $100,000. Section 25A(d).

Recognizing that these credits may not provide much relief, the act provides a new deduction for qualified tuition and related expenses incurred in the years 2002 to 2005. Section 222(a). For the years 2002 and 2003, taxpayers with adjusted gross incomes not exceeding $65,000 ($130,000 for joint filers) will be entitled to a maximum deduction of $3,000 per year. Section 222(b)(2)(A). For the years 2004 and 2005, the deduction will increase to $4,000 per year. Section 222(b)(2)(B).

Taxpayers whose income exceeds the above adjusted gross income limits but does not exceed $80,000 ($160,000 for joint filers) may deduct $2,000 per year. Section 222(b)(2)(B)(ii).

If the adjusted gross income is above these thresholds, the taxpayer will not be entitled to a deduction.

Taxpayers may not claim the new deduction and a HOPE credit or a Lifetime Learning Credit in the same year for the same student. Section 222(c)(2)(A). Note that the deduction is only available for tuition payments made in taxable years beginning after Dec. 31, 2001 and before Jan. 1, 2006. Section 222(e).

> **These provisions acknowledge the education-funding crisis and recognize that the government can help through tax incentives.**

■ **Educational-assistance plans.** One way to obtain a tax deduction for education expenses is to have the employer pay for them. Education expenses paid by an employer on behalf of its employees are generally deductible to the employer and are not includible in the income of the employee. Rev. Rul. 76-62, 1976-1 C.B. 12; Rev. Rul. 76-65, 1976-1 C.B. 46.

Another way to receive favorable tax treatment is for the employer to establish a Internal Revenue Code Section 127 educational-assistance plan. Section 127 provides for an exclusion of up to $5,250 of annual employer-provided educational assistance.

In order to qualify, the employer plan has to be in writing, cannot discriminate in favor of highly compensated employees and not more than 5 percent of the benefits can go to the owners (and their spouses and dependents) of the employer.

Historically, there have been two problems with educational-assistance plans under the current law. The available exclusion did not apply to graduate-level courses. Further, the exclusion was not permanent. It was scheduled to expire with respect to educational courses beginning after Dec. 31. Section 127(d). In the past, Congress would extend the exclusion for a number of years and let it expire, only to extend it again. Under the act, Congress extends the exclusion for employer-provided education assistance to graduate education and makes the exclusion permanent. Section 127(c)(1). By making the exclusion permanent it is hoped that more employers will implement such plans knowing that the tax benefit will not expire.

■ **Deduction for Interest on student loans.** Under current law, taxpayers can claim an above-the-line deduction for interest paid on qualified education loans up to a maximum of $2,500 of interest per year. Internal Revenue Code Section 221(a). The deduction is allowed only with respect to interest paid during the first 60 months in which interest payments are required. Section 221(d).

The deduction is phased out ratably for single taxpayers with adjusted gross incomes between $40,000 and $55,000 and for married taxpayers filing joint returns with adjusted gross incomes between $60,000 and $75,000. Section 221(b)(2)(B).

The act increases the income phase-out ranges for eligibility for the student loan interest deduction to $50,000 to $65,000 for single taxpayers and to $100,000 to $130,000 for married taxpayers filing joint returns effective for interest paid after Dec. 31, 2001. Section 221(b)(2)(B). These income ranges will be subject to inflation adjustments for years after 2002.

The act also repeals the 60-month limitation on the number of months interest can be deducted. Internal Revenue Code Section 412(a)(1). Thus, now there will be no limit on the number of months student loan interest can be deducted.

■ **Educational IRAs.** Under current law, taxpayers can establish an "education Individual Retirement Account" (now called "Cloverdale educational savings accounts"), which is a trust or custodial account created exclusively to pay higher-education expenses (undergraduate or graduate level) of a single beneficiary. Internal Revenue Code Section 530(b).

Although called an "IRA," there is no retirement benefit associated with the account. Annual contributions are made with after-tax dollars up to a maximum of $500 per beneficiary. Section 530(b)(1)(A)(iii).

Earnings in the account are not taxed until distribution. Distributions of earnings that are used to pay qualified higher-education expenses are excluded from gross income. Section 530(d)(2)(A). Earnings not so used are includible in the beneficiary's gross income and are subject to a 10 percent penalty tax.

Qualified higher-education expenses include tuition, fees, books, supplies and room and board, within certain limits. These expenses include undergraduate and graduate-level

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Boyd D. Hudson practices tax law at Adams, Hawekotte & Hudson in Pasadena. **Louis E. Michelson** is a business and tax lawyer who practices law in Sherman Oaks.

courses. The $500 contribution limit is phased out ratably for contributors with adjusted gross incomes between $95,000 and $110,000 (the thresholds are $150,000 to $160,000 for married taxpayers filing jointly).

Recognizing that the $500 contribution limit is too low, Congress, as part of the act, has quadrupled the limit on maximum annual contributions to $2,000 per beneficiary each year. Section 530(b)(1)(A)(iii). In addition, education IRA accounts now may be used for elementary and secondary education expenses, at public, private or religious schools. Section 530(b)(4)(B). The income range for phase-out is increased to $190,000 to $220,000 for joint filers. Section 530(c)(1)(a).

Contributions can be made by anyone on behalf of a single beneficiary. Individuals who may be subject to the income phase-out should consider having a friend or relative make the contribution.

■ **Section 529 plans.** Internal Revenue Code Section 529 allows states or agencies thereof to establish "qualified tuition programs" that have tax-exempt status. These programs allow for individuals to participate in a prepaid tuition program or to use a higher-education savings account. Under the latter, an individual can make contributions to an account that is established for the purpose of meeting qualified higher-education expenses of the designated beneficiary for the account.

Contributions to the account can be made only in cash, and contributors and beneficiaries are not allowed to direct the investment of contributions to the program. Generally, mutual-fund and investment companies manage such accounts on behalf of the state plans. A transfer to a Section 529 plan is treated as a gift and is eligible for the $10,000 annual gift-tax exclusion. A special provision allows a contributor to accelerate his or her annual exclusions. An individual can contribute up to $50,000 into an account for a single beneficiary and elect to treat the contributions as having been made ratably over a five-year period. Section 529(c)(2)(B).

Earnings on the amounts invested in the account accumulate on a tax-deferred basis until distributed. Under the prior law, amounts distributed or educational benefits provided to a beneficiary were included in the beneficiary's gross income to the extent the amounts or value exceeded contributions made on behalf of the beneficiary.

Section 529 plans have been marketed as an estate-planning device to grandparents to fund their grandchildren's college education by making gifts to such accounts and removing the funds from their estates.

The act expands the definition of Section 529 plans beyond state tuition programs to include programs run by private educational institutions. In a major change, the new law also provides that distributions from these accounts are excludable from gross income to the extent that the distribution is used to pay for qualified higher-education expenses.

Thus, instead of having to pay tax on earnings withdrawn from a Section 529 plan account, students will be able to withdraw earnings completely tax free as long as such expenses are used to pay for such items as tuition, fees, supplies, books, equipment and some room-and-board expenses required at a higher-education institution.

These tax-free earnings may be substantial given that a named beneficiary can have well over $100,000 in a Section 529 plan account.

The act now allows an account owner to roll over once every 12 months a distribution from one qualified tuition plan to another qualified tuition plan for the same beneficiary. Section 529(c)(3)(C) Prior law required a change in beneficiary to obtain rollover treatment.

Although the law is clear that an account owner cannot direct the investment of assets in a Section 529 plan, the rollover provisions will allow movement of assets from one state's plan to another state's plan, which may offer a better investment return or a more attractive selection of investments.

The act makes a number of significant changes and additions to the tax treatment of educational expenses. Taxpayers, especially those with college-age children, should review carefully their eligibility for such tax incentives.