STATE AND FEDERAL TAX BENEFITS FOR COLLEGE EXPENSES: THE CASE OF UTAH

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ABSTRACT
Several different federal income tax benefits exist for higher education costs. The benefits are generally mutually exclusive, and advance planning to maximize the benefits is difficult. Many states also offer tax-advantaged college savings plans (529 plans). Utah offers such a plan through the Utah Educational Savings Plan (UESP). This plan offers some state income tax benefits for account owners who are Utah residents. Because these tax benefits are unrelated to the federal tax benefits, one can potentially claim both benefits. This paper will discuss the different possible federal income tax benefits, including the qualifications and limitations which apply to them. The state tax benefits available through the UESP will also be discussed. Some discussion will also be provided showing how the different tax benefits, state and federal, are coordinated.

INTRODUCTION

Many different U.S. federal income tax benefits may be available to help those who incur costs for higher education. The federal tax benefits offered for educational costs include different exclusions, deductions, and credits. The number of different benefits and the complication of these benefits are illustrated by considering the length of the Internal Revenue Service (IRS) publication describing them. Publication 970, titled "Tax Benefits for Education—For use in preparing 2011 Returns," is 87 pages long (IRS, 2012). Some of the benefits are set by the nature of the expense and how it was paid. However, some of the benefits are choices among different possible options.

The benefits are generally mutually exclusive—the tax code does not allow a double tax benefit for a specific cost or amount—and it may be difficult to plan ahead as to which benefit might be optimal in a given situation because so many of the limitations for each possible benefit are different one from another. Most who qualify for one or more of these benefits have to calculate their tax liability after the fact using each different possible benefit to see which one maximizes the tax savings.

Many states also offer tax-advantaged college savings plans. These plans are often called 529 plans because they are authorized by Section 529 of the Internal Revenue Code (IRC) (IRC, 2012b). Utah offers a qualified tuition program through the Utah Educational Savings Plan (UESP). This plan is touted as one of the best managed 529 funds in the country (Morningstar, 2012). It also offers some state income tax benefits for account owners who are Utah residents. Because these tax benefits are unrelated to the federal tax benefits, one can potentially claim a state income tax benefit and a federal income tax benefit for the same educational expenses. Other rules exist which can help individuals increase the state tax benefits under certain conditions.

The next section of the paper will discuss the different possible federal tax benefits for education and describe the different limitations which apply to each. Included in the subsection on Qualified Tuition Programs (QTP), a description of some of the details of the qualified tuition program offered by the UESP will be given. This description will include the state tax benefits available through that plan. A further section will discuss the coordination of the different tax benefits for education. This section will be followed by a discussion section and a conclusion.

FEDERAL TAX BENEFITS FOR EDUCATION

IRS Publication 970 (IRS, 2012) includes 12 chapters describing different federal tax benefits relating to the payment of educational costs. Some of these benefits are more pertinent to this paper than others: American Opportunity Credit, Lifetime Learning Credit, Coverdell Education Savings Accounts (ESA), and Qualified Tuition Programs (QTP). These will be described in separate subsections. The final subsection will briefly mention the education tax benefits which are not as relevant to this paper. This subsection will add to the understanding of the scope of the many federal income tax benefits available relating to education costs. The discussion in this paper refers to tax laws effective for 2012. As tax laws are subject to change, education tax benefits available after 2012 could possibly be different.

American Opportunity Credit (IRS, 2012)—For 2009, 2010, 2011 and 2012, the American Opportunity Credit has been in effect, liberalizing some of the limitations of the Hope Scholarship Credit (IRC, 2012a). The maximum credit is $2,500 per eligible student per year for up to the first four years of postsecondary education for that student (including any years the Hope credit was claimed for that student). The credit is 100 percent of the first $2,000 of qualified education expenses paid for the eligible student plus 25 percent of the next $2,000 of expenses. The eligible student must be pursuing a degree or other recognized education credential, must be enrolled at least half time for at least one academic period during the tax year, and must not have been convicted of a felony for possessing or distributing a controlled substance by the end of the year.

A taxpayer can claim the credit if he/she pays qualified education expenses of higher education for an eligible student who is either himself/herself, his/her spouse, or a dependent for whom an exemption is claimed (but if you are listed as a dependent on another person's tax return, you cannot claim the credit). However, you cannot claim this credit if you claim the Lifetime Learning Credit for the same student for the same year.

Up to 40 percent of the credit may be refundable, with the rest nonrefundable. The credit is phased out based on the taxpayer's modified adjusted gross income (MAGI). For those who are married filing jointly, the phaseout begins at a MAGI of $160,000; those with MAGI in excess of $180,000 cannot claim the credit. Those who are married filing separately cannot claim the credit. For those with another filing status, the phaseout begins at a MAGI of $80,000 and is complete at a MAGI of $90,000.

The expenses which can qualify for this credit include tuition, required fees, and course materials the student needs for the course of study. If you pay for qualified expenses using certain tax-free funds (such as tax-free scholarships and fellowships, Pell grants, employer-provided educational benefits, veteran's educational benefits, etc.), these amounts must be subtracted from the qualified educational expenses before the credit can be calculated. Qualified expenses paid in the current tax year for academic periods beginning that year or within the first three months of the following year can be used to claim the credit. If you claim an exemption on your tax return for a dependent who is an eligible student, expenses paid by you, by the dependent, or by others count as payments made by you for purposes of claiming this credit.

Lifetime Learning Credit (IRS 2012)—The Lifetime Learning Credit is also available to reduce the costs of higher education. This credit is available for all years of postsecondary education with no limit to the number of years it can be claimed. The maximum credit is $2,000 per tax return, not per student, and is calculated as 20 percent of the first $10,000 of qualified education expenses paid for all eligible students. However, this credit cannot be claimed for the same student in a year when the American Opportunity Credit is claimed for that student. The eligible student does not need to be pursuing a degree, can be taking any number of courses, and can have been convicted of a felony drug offense.

A taxpayer can claim the credit if he/she pays qualified education expenses of higher education for an eligible student who is either himself/herself, his/her spouse, or a dependent for whom an exemption is claimed (but if you are listed as a dependent on another person's tax return, you cannot claim the credit). This credit is nonrefundable. It also has a MAGI phaseout range, but the range is different for this credit than it is for the American Opportunity Credit. For those who are married filing jointly, the phaseout range is between $104,000 and $124,000. Those who are married filing separately are not eligible for the credit. For those with a different filing status, the phaseout range is between $52,000 and $62,000. These limits are indexed and have increased over time.

The expenses which qualify for this credit include tuition and fees required for attendance, including any amounts required to be paid directly to the institution for course-related books, supplies, and equipment. The course(s) taken must be either part of a postsecondary degree program or taken to acquire or improve job skills (even though the student does not need to be pursuing a degree). Any expenses paid with tax-free funds must be subtracted before determining the expenses eligible for the credit. As with the American Opportunity Credit, expenses paid in the current year for academic period beginning that year or within the first three months of the next year can be used in calculating the credit. If you claim an exemption on your tax return for a dependent who is an eligible student, expenses paid by you, by the dependent, or by others count as payments made by you for purposes of claiming this credit.

Coverdell Education Savings Account (ESA) (IRS, 2012)—A Coverdell Education Savings Account (ESA) is a trust or custodial account that can be set up for a designated beneficiary's qualified education expenses. The trustee or custodian must be a U.S. bank or other entity approved by the IRS. The account must be specifically established as a Coverdell ESA and must be established before the beneficiary reaches age 18 (unless the beneficiary is a special needs beneficiary). Contributions to an ESA are not deductible, but the amounts in an ESA grow tax free until distribution. When distributions are made, the earnings will also be tax free to the extent the distributions do not exceed the beneficiary's qualified education expenses for that year.

A Coverdell ESA must be funded with cash contributions, and the contributions must be made before the beneficiary reaches age 18 (unless the beneficiary has special needs). Contributions for a given tax year must be made by the original due date of the contributor's tax return. Total contributions to all Coverdell ESAs for a specific beneficiary in a given year cannot exceed $2,000. The balance in a Coverdell ESA must be distributed within 30 days of the beneficiary's 30th birthday (unless the beneficiary has special needs) or within 30 days of the beneficiary's death, whichever comes first. To be eligible to contribute to a Coverdell ESA for any beneficiary, the contributor's MAGI must not exceed $110,000 ($220,000 in the case of a joint return for a married couple), and eligibility to contribute is phased out for those with MAGI greater than $95,000 ($190,000 for joint returns).

Qualified education expenses for a Coverdell ESA are different from those defined by the credits described above. The expenses can be either qualified higher education expenses or qualified elementary and secondary education expenses. In addition, contributions from a Coverdell ESA to a qualified tuition program (discussed next) for the same beneficiary also meet the definition of qualified education expenses. In relation to a Coverdell ESA, qualified higher education expenses would include tuition, fees, books, supplies, and equipment required for enrollment or attendance. Expenses can also qualify if they are for special needs services provided to a special needs beneficiary. Room and board costs can also qualify if the student is enrolled at least half-time. Qualified elementary and secondary education expenses include the following items if incurred by an eligible beneficiary relating to enrollment or attendance at an eligible school: tuition, fees, books, supplies, equipment, academic tutoring, and special needs services. Expenses for room and board, uniforms, transportation, and supplementary items and services can also qualify if they are required or provided by the school in connection with enrollment. In addition, costs for computer technology, equipment or Internet access can also qualify under certain conditions.

If distributions from a Coverdell ESA exceed adjusted qualified education expenses (qualified education expenses reduced by tax-free education assistance), the earnings on the excess distributions become taxable. In addition, with certain exceptions, if the distributions exceed qualified education expenses, an additional 10 percent tax is applied as a penalty since the tax-deferred accumulation was supposed to be for education expenses.

Qualified Tuition Program (QTP) (IRS, 2012)—States or eligible educational institutions can establish and maintain qualified tuition programs which allow accounts to be set up to prepay or contribute to an account to pay a student's qualified higher education expenses. Contributions to a QTP are not deductible, but the accounts grow tax free. In addition, no tax is due on the distributions unless the amount distributed exceeds the adjusted qualified education expenses. Any qualified education expenses paid with tax-free education assistance must be subtracted in calculating the adjusted qualified education expenses. If the distributions from a QTP exceed the adjusted qualified education expenses because some qualified expenses were paid with tax-free education assistance, a proportionate amount of the earnings included in the QTP distribution will be taxable to the beneficiary.

Qualified education expenses for this tax benefit include tuition and fees, books, supplies, and equipment required for enrollment or attendance at an eligible institution. Costs for special needs services can also qualify if the beneficiary has special needs. If the student is enrolled at least half-time, room and board costs can also qualify. In addition to the proportionate taxability mentioned above, if QTP distributions exceed qualified education expenses, any income earned on the QTP distribution in excess of qualified education expenses becomes taxable to the beneficiary. With some exceptions, this taxable distribution is also subject to a 10 percent additional tax since the purpose of this account was to accumulate amounts to pay for qualified education expenses.

Since these programs are designed for the payment of qualified education expenses, contributions for a beneficiary cannot exceed the amount necessary to provide for qualified education expenses. There are no income limits on those who contribute to a QTP.

Utah Educational Savings Plan (UESP, 2011). Utah's qualified tuition program is operated by the Utah Educational Savings Plan (UESP). This plan allows earnings to accrue free from federal and state income taxes while invested in a UESP account. The earnings are exempt from federal and state taxes if used for qualified higher education expenses.

UESP is a top-ranked 529 plan; in 2012 it was one of only four plans to receive Morningstar's gold (highest) rating (Morningstar, 2012). Because IRC Section 529 was set up to provide tax benefits for college savings rather than to provide tax-deferred savings for other purposes, contributions to a UESP account can only be made if the aggregate balance for any single beneficiary in UESP accounts is less than $390,000 for 2012. This limit is indexed and can increase over time.

Any U.S. citizen or resident alien can open a UESP account, providing that he/she is at least 18 years old, has a valid U.S. Social Security or Taxpayer Identification number, and has a physical U.S. address other than a P.O. Box. Trusts, partnerships, and corporations can also be account owners with a designated agent. However, this paper will focus only on individual account owners. The account owner maintains control of the account, including how and when the money in an account is used.

A state income tax credit is available to Utah taxpayers for contributions to a UESP account if the beneficiary is under age 19 when the account is established. The credit for an individual is calculated as 5 percent of the amount contributed for a specific beneficiary and is limited for 2012 returns to amounts contributed up to $1,780 per beneficiary ($3,560 per beneficiary for those who are married and filing a joint return). This limit is indexed, so the maximum credit per beneficiary can increase from year to year. If funds are rolled over from UESP to another 529 plan, Utah taxpayers must recapture any previously claimed state income tax credit relating to the amounts rolled over.

UESP offers multiple investment options with varying risks. As most of the investment options include investments in bonds and equities, the potential exists to lose money in a particular investment option. Investment expenses and administrative fees are charged for investments in the different funds. However, one of the reason the UESP has a top rating is the low expenses charged, thus leaving more in the fund to continue to grow.

Other Federal Tax Benefits (IRS, 2012)—Scholarships and fellowships received are exempt from income taxes if (1) the recipient is a candidate for a degree at an eligible institution, (2) the scholarship or fellowship is used to pay qualified education expenses, and (3) the payment does not represent payment for services such as teaching, research, or other services required to receive the scholarship (with limited exceptions). For this exemption, qualified education expenses would include tuition and required course-related expenses for fees, books, supplies, and equipment. Room, board, and travel expenses are not qualified education expenses for this exemption.

Grants such as Fulbright grants and Pell grants, may also be exempt from federal income taxes. Fulbright grants are usually treated as scholarships or fellowships and would be tax exempt as determined by the rules for scholarships. Pell grants are exempt from taxes to the extent they are used for qualified education expenses.

A qualified tuition reduction is also exempt from federal income taxes. For example, many colleges and universities offer free or reduced tuition to employees and their dependents. These amounts may be a qualified tuition reduction, with the rules for qualification depending on whether the education is below the graduate level or at the graduate level.

Interest paid on a qualified student loan can be deducted in calculating taxable income. The maximum amount of interest that can be deducted in a year is $2,500. This tax benefit is also limited by the amount of MAGI. Those who are married and filing joint returns can claim this deduction, but the deduction is phased out for MAGI levels between $125,000 and $155,000. Those who are married filing separately cannot claim the deduction. For those with a different filing status, the phaseout MAGI for this deduction is between $60,000 and $75,000. The MAGI phaseout limits are indexed and can change over time.

Typically a loan which is forgiven results in taxable income. However, under certain conditions, a student loan which is cancelled is exempt from federal income tax. In addition, if student loan repayment assistance is received under specific plans which are designed to increase the availability of health services in underserved areas or health professional shortage areas, the assistance received is exempt from taxes.

Individual retirement accounts (IRAs) are tax-advantaged vehicles used to save for retirement. The earnings are taxed on a deferred basis rather than a current basis. In addition, contributions to some types of IRAs can be made with pre-tax money. Because IRAs are tax advantaged, withdrawals from these accounts before age 59½ result in a 10 percent additional tax. This 10 percent additional tax is due on top of any tax that would normally be assessed because earnings and pre-tax contributions become taxable upon withdrawal. However, if the amounts withdrawn from an IRA prematurely are used for qualified educational expenses for a qualified individual, they will not be subject to the 10 percent additional tax. For this exemption from the 10 percent additional tax, qualified education expenses include tuition, fees, books, supplies, and equipment required for enrollment. Costs for special needs services for special needs students can also qualify. In addition, if the qualified individual is at least a half-time student, costs for room and board are also qualified education expenses.

Interest earned on U.S. savings bonds is generally taxable. However, if such interest earned on a series EE bond issued after 1989 or a series I bond is used for qualified education expenses for a qualified individual, the interest can be exempt from income taxes. This benefit also has a MAGI phaseout range which has been indexed over time. The exemption is not available to those who are married filing separately. For those filing joint returns in 2012, the MAGI phaseout range is from $109,250 to $139,250. For others, the MAGI phaseout range is $72,850 to $87,850. To avoid receiving a double tax benefit, the qualified education expenses eligible for exemption under this tax benefit must be reduced by tax-free payments and expenses used to calculate other income tax benefits for education expenses.

Some employers offer educational assistance as an employee benefit. If the employer has a written plan which meets certain conditions, an employee can exclude up to $5,250 of these benefits each year. The assistance must be for tuition, fees, books, supplies, or equipment.

A business deduction is also allowed for costs incurred for qualifying work-related education. Work-related education is specifically defined by the internal revenue code, but the definition is beyond the scope of this paper. If you are an employee and itemize deductions, you can include these costs in your itemized deductions, but only to the extent they exceed 2 percent of your adjusted gross income (AGI). If you are self-employed, you can deduct these costs in calculating your self-employment income.

COORDINATION OF TAX BENEFITS

As has been mentioned previously, the IRS does not allow a double benefit for the same expense item. This is true of the different tax benefits for education costs. For example, a taxpayer cannot claim in the same year for the same student both the American Opportunity Credit and the Lifetime Learning Credit. These potential tax benefits are mutually exclusive because both relate directly to education expenses paid in the current tax period. In addition, as mentioned previously, tax-free education assistance amounts must be deducted in calculating the expenses which qualify for these credits. This is because these tax-free benefits also relate to alternative ways to pay for current educational expenses.

The differences in limitations or qualifications for these two credits include the following: the MAGI phaseout limitations, the dollar limits, the difference between a per student or a per tax return limit, the percentage applied in calculating either credit, limits related to student eligibility, differences in the definition of qualified education expenses for the credit, and whether the credit is refundable or not. Because these differences exist, the best tax benefit may not be apparent in advance and may need to simply be calculated after the fact when the tax return is prepared. Things were even more complicated in 2011 when the Tuition and Fees Deduction (with even different qualifications and limitations) was another option but which could not be claimed for the same student if either of the credits were claimed for that student that year.

Other tax benefits for education such as the student loan interest deduction or the student loan cancellation and repayment assistance exclusion do not relate to current education expenses. Instead, they relate to education expenses previously incurred which are now part of a student's debt portfolio.

Still other tax benefits for education relate to encouraging savings for future education expenses. A Coverdell ESA or a QTP are examples of the tax benefits that fit in this category. Because these tax benefits relate to the accumulation of amounts to pay for future education expenses, they are not benefits that have to be mutually exclusive with the credits or deduction for current expenses. However, because the IRS does not allow a double tax benefit for the same expense, coordination may be needed. Therefore, if the distributions from a Coverdell ESA and a QTP exceed a student's adjusted qualified education expenses in a given year, the expenses must be allocated between the distribution from the ESA and the distribution from the QTP in calculating how much of the earnings from each distribution becomes taxable (IRS, 2012).

It is also possible for distributions from a Coverdell ESA or a QTP to be used to claim the American Opportunity Credit or the Lifetime Learning Credit. However, since the same expense cannot be used for two benefits, any amount of a distribution used in calculating one of the credits must be further subtracted in calculating adjusted qualified education expenses in calculating the taxability of any earnings from the distribution. For example, if the parents claim a $2,500 American Opportunity Credit based on $4,000 of qualified education expenses and a QTP distribution is made to pay for these expenses, then the adjusted qualified education expenses would be calculated by subtracting that $4,000 from qualified education expenses (in addition to subtracting any tax-free education assistance). In the calculation of how much of the QTP distribution becomes taxable, the adjusted qualified education expenses amount is divided by the QTP distribution, and that fraction of the earnings on the distribution is tax-free, with the remaining portion of the earnings on the distribution becoming taxable (IRS, 2012).

DISCUSSION

Something interesting happens in the situation above if some of the QTP distribution earnings becomes taxable because the expenses were used to claim the American Opportunity Credit. Even though it might have been the student's parents who claimed the credit, the taxable portion of the earnings become taxable to the beneficiary, not the parents. This is probably helpful in most situations, as the beneficiary is likely in a lower tax bracket than are the parents. So the parents get the advantage of the tax credit, but the beneficiary has to claim as income the portion of earnings that becomes taxable because the parents claimed the credit.

Of course, the intent of the Coverdell ESA and a QTP is for the parents (and perhaps others) to save for a child's education throughout his/her life. If an account is created when the child is born, more can be contributed to the account over time, and the account has a longer period of time to accumulate tax-free earnings. This is really the ideal way for parents to use the tax benefits to help a child receive a postsecondary education.

The Utah State tax credit for UESP contributions is a credit given as amounts are contributed to a UESP account and start to accumulate. The major federal tax benefits are granted at the time education expenses are paid. However, it is still true that both benefits are available for the same costs of education. For certain specific dollars, theoretically a 100 percent federal credit and a 5 percent credit are available for the same expenses, thus making those amounts negative expenses when netted with the tax benefits.

Even if a Utah resident does not start to save for a child's education when the child is born and therefore pays education costs out of pocket at the time the child begins postsecondary education, it might still be worth funneling the costs through a UESP account, at least any amounts that can qualify for the 5 percent state credit. If the amounts are contributed to a UESP account and fairly immediately withdrawn, they can still qualify for the state credit up to the credit limit.

Also, if parents have several children and have not opened UESP accounts for them early, the accounts could be opened before they turn 19, thus keeping them eligible for the state tax credit for contributions. Then if education expenses are paid out of pocket concurrent with enrollment, parents could theoretically contribute amounts to multiple accounts (up to the limit for the credit), get the credit for contributions to multiple accounts, and then transfer amounts from younger children's accounts to those of the older child who is currently in school and incurring qualified education expenses. This way, although the parents have not saved for the education expenses in advance, they could maximize the state tax credit by using multiple accounts.

CONCLUSION

The federal government is generous in trying to facilitate higher education by providing tax benefits for education. This paper has discussed the many federal tax benefits relating to costs of higher education. It has also provided information on the Utah Education Savings Plan, a specific QTP operated by the state of Utah, which offers a state tax credit for contributions made by Utah taxpayers. Taxpayers may be able to claim the state tax credit and a federal tax benefit for the same expenses, but no double federal benefit is allowed. Because there are so many different federal benefits, it is hard to coordinate them to pursue advance tax planning. However, it is possible to calculate the total tax liability using each of the different benefits to see which one provides the greatest net benefit. Different people may be benefited by different benefits based on varying qualifications and limitations.

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