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Education Deductions and Credits

If you, your spouse or your dependent is in college, thinking of going to college, wants to obtain more education, continuing education or study, wants to improve maintain their skills, now is the time to read the information as it pertains to education.

This is an area where taxpayers can make some significant planning opportunities and reduce their taxes at the same time.

A deduction reduces taxable income -- it is not as beneficial as a credit that reduces the amount of tax one pays.

Education expenses can be broken down into credits and deductions. The credits will reduce your overall tax liability the most and careful planning is needed since taking advantage of one benefit may exclude you from others that could net a larger tax deduction. Parents of college-bound kids are probably well aware of the staggering costs. According to the College Board, sending Junior away in 2002 for four years to a state college will cost more than $38,000 on average, including tuition, fees, room and board.

The tab at a private school is just a touch under $100,000. Even worse, these prices in the near term are rising at an average 5 percent a year. Washington is providing one new break as well as liberalizing the rules for several others to aid those who foot the bills.

You can pay for primary, secondary, and higher education expenses for family members as well as yourself. Now it is possible that the same education expense can qualify for any number of deductions or credits.

College Cost Deduction

This brand-new tax break lets you deduct up to $3,000 of college tuition and fees paid for you, your spouse and any dependents. It's an "above-the-line" deduction, meaning you don't have to itemize. It reduces your taxable income.

Those eligible are single tax filers with modified adjusted gross income (AGI) below $65,000 and joint filers under $130,000. No phase-out rules apply, but spouses who file separately are also ineligible.

Also, this deduction can't be claimed for expenses paid with tax-free withdrawals from a Section 529 plan or an Education IRA, nor can it apply to expenses used to claim the Hope Scholarship or Lifetime Learning tax credits (see below). *It applies only to post-2001 payments.*

Hope Scholarship and Lifetime Learning Tax Credits

These two have been around for a while but their limits are being revised upward to appeal to more middle-income taxpayers.

The Hope Scholarship credit is a maximum of $1,500 per qualifying student per year -- 100 percent of the first $1,000 of a college student's annual tuition and fees (no room and board costs), plus 50 percent of the next $1,000.

Unfortunately, it can be claimed for only two tax years and is unavailable after the student has two years' worth of academic hours. Also, the Hope credit is only allowed when the student carries at least half of a full-time load for at least one academic period beginning in the year the credit is claimed.

The Lifetime Learning credit is intended to pick off where the Hope Credit left off, helping to defray college costs after the first two years. It's less restrictive since it's available for an unlimited number of years and doesn't carry any course load requirements. Therefore, graduate courses and non-degree classes, such as professional training seminars and skill refresher courses, are allowed.

The Lifetime credit equals 20 percent of qualifying tuition and fees up to $5,000 for a maximum credit of $1,000 per year, which applies regardless of how many students are in your family. Starting in 2003, the Lifetime credit becomes more generous, equaling 20 percent of tuition and fees up to $10,000, for a maximum annual credit of $2,000. Qualifying expenses for both the Hope and Lifetime credits include post-secondary tuition and fees for you, your spouse, and any dependent claimed on your tax return. The AGI phase-out ranges have been increased for 2002 but still rule out many high-wage earners. Both credits are phased out for joint filers earning $82,000-$102,000 for joint filers and single filers earning $41,000-$51,000.

You're completely ineligible if married and filing separately from your spouse.

College Loan Interest Rules

Thanks to more relaxed rules for the deduction of school loan interest, many school alumni who weren't able to take advantage of this tax break can do so now. If you qualify, you can write off up to $2,500 of annual interest charges. The catch, of course, is that this break is phased out if your modified AGI is too high. Fortunately, the phase-out range is higher in 2002 and beyond. The new range for single taxpayers is now between $50,000 and $65,000 (up from $40,000-$55,000). For joint filers, the new range is between $100,000 and $130,000 (up from $60,000 $75,000). Also effective in 2002, the rule for deducting only 60 months' worth of interest is repealed, meaning you can now deduct interest charges for as long as it takes to repay the lender.