

June 2003

Pomp and Circumstance -- and Beyond

May and June are graduation months. Many of you will be listening to the stirring strains of Edward Elgar's famous march and watching with pride as your children or grandchildren make that long awaited walk dressed in their caps and gowns. If there is a high school graduate in your family, you likely have already spent some time thinking about the financing of his or her higher education.

One recent survey of parents revealed that the second greatest fear of American parents is paying for their children's college education. Perhaps that fear is related to the results of a USA Today study which revealed that 56% of parents surveyed had saved nothing for their children's college costs. Of those who had saved, only 4% had put away more than \$5,000. When compared to the Department of Education figures on college costs it is easy to understand the reason for parents fears. Average, annual costs are currently estimated as follows:

Community Colleges	\$ 5,400
State Colleges	\$ 8,300
Private Colleges	\$20,800
Ivy League Colleges	\$33,500

College costs are currently escalating at approximately 7% per year which is about twice the normal rate of inflation.

Congress has reacted to these concerns by enacting tax legislation to help parents and students responsible for paying college costs. The tax savings are often subject to phase out for higher income taxpayers, and limitation of benefits when combined in the same year. The majority of those programs are detailed in the following table.

Description	Tax Benefit
1. Student Loan	Interest Deduction
2. Higher Education Expense	Deduction
3. Education Savings Bonds	Income Exclusion
4. Qualified Tuition Programs (QTP)	Income Exclusion
5. Education IRA's and Other IRA's	Income Exclusion
6. Scholarships, Fellowships, Grants and Tuition Reductions	Exclusion
7. Hope Credit	Credit
8. Lifetime Learning Credit	Credit

The scope of this article will not allow a complete explanation of each of the above benefits, but hopefully will give enough information that you can decide whether or not they will be of benefit in your situation.

1. Student Loan Interest: This has been deductible since 1998. It is an "above the line" deduction on the front page of the 1040. It is limited to \$2500 per year and is subject to a phase out for higher income taxpayers.

2. Higher Education Expense Deduction: The tax act of 2001 created a new, "above the line" deduction for qualified higher education expenses. As the law currently reads, this deduction will not be allowed after 2005. It is also limited for higher income taxpayers and can not be taken in the same year as the Hope or the Lifetime Learning Credits.

3. Education Savings Bonds: An individual who redeems qualified, U. S. Savings bonds may exclude the interest from taxable income up to the amount of qualified higher education expenses. The qualified higher education expenses are specifically defined. The bond must be registered in the name of the taxpayer or taxpayer and spouse (i.e. not in the name of the dependent child). This benefit phases out based on the taxpayers modified adjusted gross income.

4. Qualified Tuition Programs: These programs are set up by the individual states. Their provisions and restrictions vary from state to state. They are of two basic types and allow the taxpayer to prepay either specified amounts for tuition or amounts for qualified higher education expense. The interest buildup on these funds is not taxed. These provide a good, long range planning opportunity.

5. Education IRA's and Other IRA's: The Coverdell Education Savings Account allows the taxpayer to set up a Roth IRA type account in the name of a designated beneficiary. The proceeds are specified to be used for education. They can be used for elementary and secondary education as well as higher education. The contributions are subject to limitation and phase out. This is also a good long range planning opportunity and can provide an opportunity for grandparents and other relatives and friends to participate. Early distributions from both Roth and regular IRA's are not subject to the 10% penalty tax if the proceeds are used for qualified higher education expenses.

6. Scholarships, Fellowships, Grants and Tuition Reductions are generally excluded from income as long as the money is used for its intended purpose. The exclusion does not apply to amounts received as payment for teaching, research, room, board or other incidental services.

7. Hope Credit: The Hope Credit is a maximum reduction in tax of \$1500 per year for each eligible student. It may be claimed against tuition and fees for the first two years of post secondary education. There are numerous requirements for eligibility, and a formula which must be applied to determine the amount of the credit. It is subject to phase out for higher income taxpayers.

8. Lifetime Learning Credit: The Lifetime Learning Credit is a maximum reduction in tax of \$1000 per year or 20% of tuition and fees, whichever is smaller. It is available per taxpayer and is not limited to the first two years. It also is subject to numerous restrictions, and is phased out for higher income taxpayers. Several definitions and restrictions are common to both of these credits.

As you can see, there is help available for the financing of your children's education, but it requires effective planning to maximize the potential benefits. The office has access to all of the details and requirements of each program, as well as the interrelationship of the benefits, and can help you map out a strategy that will work to your best advantage, so please feel free to give us a call.

Very Truly Yours,

Krebs & Co., CPA's, Inc.
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