AICPA

Tax and financial planning tips: Education costs

A good education can be a stepping stone to a bright future, but it can also be a big financial burden. Whether it's the first day of kindergarten at a private school or a second graduate degree, paying for an education has major tax consequences. But a little planning can help start things off right. Here are some tax and financial planning tips to keep in mind.

Education savings plans

Saving for future education costs can help parents fund their child's education through federal and state-sponsored plans or tax-advantaged income exclusions.

Section 529 plans — 529 savings plans allow for annual tax-free distributions per beneficiary (regardless of the number of contributing plans) for qualifying expenses. Beginning in 2018, these plans can fund the educational costs of students in grades K–12 who are enrolled in religious and other private schools. However, distributions for grades K–12 cannot exceed $10,000 per beneficiary, and not all state-sponsored plans have adopted the expanded use of these funds.

Note: The IRS treats contributions to 529 plans as gifts for tax purposes, but they're eligible for the annual gift tax exclusion.

Prepaid tuition plans — Some states offer prepaid tuition plans that lock in future tuition costs at current rates. Most plans have residency requirements. Only 18 state-sponsored plans exist and only 11 of these are accepting new applications. Distributions from prepaid tuition plans generally are limited to expenses for tuition and fees.

Coverdell education savings account (ESA) — Like 529 plans, Coverdell ESAs can help pay for education costs. They can also help pay for school expenses such as tutoring, uniforms and books at K–12 schools. Benefits phaseout completely for single filers with a modified adjusted gross income (MAGI) of $110,000 and $220,000 for married couples filing jointly. The total amount of contributions to these plans cannot exceed $2,000 per year.

United States savings bonds — Individuals who purchase U.S. savings bonds for higher-education costs may exclude interest earned on these bonds up to the cost of the qualifying education expenses. Phaseout for this exclusion begins after a taxpayer's MAGI exceeds $79,700 ($119,550 for married filing jointly). This exclusion is not available for married taxpayers who file separately.

Education costs

Evaluate the costs associated with different types of institutions (private vs. public, for example), when deciding how much you need to save.

Exclusions and deductions from income

Some income used for education expenses can qualify for an exclusion. Other education expenses could be eligible for a deduction or credit.

Student loan interest deduction

Some individuals may deduct up to $2,500 on qualified student loan interest paid during the year on qualified education.

Phase-out starts at adjusted gross incomes over $65,000 ($135,000 for married filing jointly). Married individuals who file separately may not claim the deduction.

Employer-provided education assistance — Employees who work for a company that has a qualified educational assistance program may exclude up to $5,250 per year in education assistance as a tax-free benefit if these funds are used for qualified expenses.

Student loan debt cancellations — Cancelled debt generally becomes taxable income to an individual, but certain students may exclude canceled government student loans from income if the student works for a specified amount of time in specific professions.

Student loan repayment assistance — Student loan repayment assistance made by an employer on behalf of their employee is tax-free to the recipient in some cases. Generally, a student must work in a qualified profession for these payments to be excluded from income.

Timing of education costs

Determine the timing of when the costs will occur and be sure to consider inflation (college expenses have historically run at about two times the general inflation rate).

Miscellaneous tips

Some students have special considerations complicating their tax situation.

Child and dependent care tax credit — Those going back to school may qualify for the child and dependent care tax credit. This credit allows married couples filing jointly to claim up to $3,000 in child care expenses per qualifying individual (up to $6,000). Married couples claiming the credit must both be working and file jointly. How much a couple can claim depends on their income.

Note: A parent must have custody of the child for more than 50% of the year to qualify for this credit. The qualifying child must be under the age of 13 and claimed on the tax return as a dependent.

American Opportunity Tax Credit (AOTC) — Individuals may receive up to a $2,500 credit during the first four years of post-secondary education for an eligible student. The credit is based on qualified tuition and related expenses paid during the tax year. The amount to be refunded cannot exceed 40% of the total credit. Phaseout starts at $80,000 MAGI ($160,000 for married filing jointly), and those with a MAGI above $90,000 ($180,000 for married filing jointly) may not claim the credit.

Lifetime Learning Credit (LLC) —Similar to the AOTC, some students enrolled in eligible educational institutions may receive a credit of 20% of qualified education expenses — up to $2,000 — for themselves or any qualifying dependent they claim on their tax return.

Pell grants — These funds are excluded from income if used for qualified tuition and related expenses.

Scholarships — Scholarships for tuition and fees are nontaxable if they're used for those purposes. Even if a stipend is used for tuition and related expenses, it'll be considered taxable income. Qualifying expenses the scholarships cover cannot be used for the AOTC or LLC.

Retirement accounts — IIf allowed by the plan, taxpayers may borrow against their retirement accounts or withdraw funds from them. Depending on the type of plan, distributions may be made without incurring the 10% early-withdrawal penalty. However, distributions from certain retirement plans (e.g., traditional IRAs or 401(k)s) are subject to regular income tax.

Funding intervals

Establish a funding interval that works based on your cash flow situation. It might be annually or even weekly, based on your family's situation.