Get Your Tax Dollars Back

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It is said that nothing is certain in life except death and taxes. If you are going to college or are the parent of a college-bound student, then you can add one more certainty to life and that is this: tuition bills. Fortunately, Uncle Sam acknowledges this reality and offers several valuable tax credits and deductions. These tax breaks literally put money back in your pocket to help you pay those inevitable tuition bills.

The challenge with tax breaks is two-fold. First, you need to decipher the tax codes to determine if you actually qualify for a tax break. Most have income limits and other requirements that restrict their use. Second, if you qualify to take advantage of multiple tax breaks, you need to figure out which combination will give you the most benefit. To complicate matters (and you shouldn't expect anything less from the IRS), some of these tax breaks are mutually exclusive, which means you'll have to choose one over the other.

Remember too that tax laws as well as their interpretations change each year. Please check the requirements of these tax benefits with your accountant or by downloading the latest version of IRS publication 970 at http://www.irs.gov.

STEP 1

Give yourself up to $1,650 with the Hope tax credit.

The Hope tax credit reduces your taxes dollar for dollar and is like putting money directly into your pocket. You can receive up to $1,650 in Hope credits per student. However, the Hope credit can only be claimed for students who are college freshman or sophomores. Once a student is past his or her sophomore year, you cannot claim this credit. Also, repeating a year doesn't count.

To figure out how much of the Hope tax credit you can claim per student in your family, look at the total amount of money that you paid out of your own pocket for tuition. The Hope credit can only be used for tuition, not room and board and other expenses. So if you are using 529 or Coverdell money, you'll want to tap it for room and board and use some of your own funds to pay for tuition. Once you know how much you've paid out of pocket for tuition, you can claim 100 percent of the first $1,100 and 50 percent of the next $1,100 that you paid. In other words, to claim the full $1,650 per student, you must have paid at least $2,200 in qualified education expenses for that student.

To claim the Hope tax credit, you must also meet the income requirements. For a single taxpayer, you can get the full credit if your modified gross adjusted income does not exceed $45,000. If it does but is below $55,000, you can claim a partial credit. For married couples filing jointly, you can get the full credit if your income does not exceed $90,000. If you earn more but are still below $110,000, you can claim a partial credit.

STEP 2

Get up to $2,000 with the Lifetime Learning credit.

The Lifetime Learning credit is similar to the Hope credit and reduces the tax you owe dollar for dollar. But unlike the Hope credit, the Lifetime Learning credit can be used for any student for any year of college, graduate school or even continuing education. However, you cannot claim both a Hope and a Lifetime Learning credit on the same student in the same year. It is usually to your advantage to claim the Hope for the first two years and then the Lifetime Learning credit for the next two years. The income limits to qualify for the Lifetime Learning credit are the same as those for the Hope credit.

If you are an adult student who has already completed your first two years of undergraduate work or are taking continuing education courses or if you are a graduate school student, then you have no choice but to take the Lifetime Learning credit.

The maximum amount of the Lifetime Learning credit is $2,000 per tax return, which is calculated by taking 20 percent of what you pay for tuition (not room and board or other expenses) up to $10,000. This means that to claim the full $2,000 credit, you must spend $10,000 or more out of your own pocket on tuition. Money that you are already receiving a tax benefit on (like the tax-free earnings portions of Coverdell and 529 Plans or scholarships) don't count in determining how much you spent. The IRS doesn't allow double-dipping—getting more than one tax benefit on the same source of money.

STEP 3

Choose your tax credit wisely.

You can claim only one tax credit per student per year, which means you need to decide whether to claim the Hope or Lifetime Learning credit if you qualify for both. If you have two students in college at the same time, you can claim a Hope credit on one and a Lifetime credit on the other.

Since you can claim only one of the credits for each student per year, make sure that you take advantage of them in the right order. If you qualify for both, you probably want to use the Hope credit in the first two years and then the Lifetime Learning credit in the years thereafter. The Hope credit also lets you qualify for the full amount while using less of your own money.

STEP 4

Deduct your tuition and fees.

Tax deductions are not as good as tax credits, but they do reduce your taxable income, which means you will still pay less taxes. A deduction for education can be taken on money that you used to pay for tuition and fees. This can be the tuition that you paid either for yourself, a spouse or a dependent child. You can deduct up to $4,000 of tuition expenses (not room and board or other expenses) that you paid for each student as long as you are not also claiming a Hope or Lifetime Learning credit on the student. This is part of the "no double-dipping" rule, which also means that you cannot deduct any tuition expenses that you paid with tax-free money such as funds from Coverdell, scholarships or 529 Savings Plans.

To claim an education tax deduction, you must again meet income requirements. A single taxpayer with a modified adjusted gross income (MAGI) of $65,000 or less or a couple filing jointly with an MAGI of $130,000 or less can take the deduction. If the MAGI is between $65,000 and $80,000 ($130,000 and $160,000 married filing jointly), the maximum deduction is $2,000.

Since the income limits for this deduction are higher than those of the Hope or Lifetime Learning credits, some taxpayers find that even though they do not qualify for the tax credits, they can still take a deduction on tuition costs.

STEP 5

Deduct your student loan interest.

All student loan interest that you pay is tax deductible up to $2,500 per year. The loan must have been used for qualified higher-education expenses, including tuition, fees, room and board, supplies and other related expenses. The maximum allowable deduction is gradually reduced for single taxpayers whose modified adjusted gross income exceeds $50,000 but is below $65,000 and for married taxpayers filing jointly whose MAGI exceeds $105,000 but is below $135,000.

You can usually count as interest the loan-origination fees (other than fees for services), capitalized interest, interest on revolving lines of credit and interest on refinanced student loans, which include both consolidated loans and collapsed loans. You can also count any voluntary interest payments that you make. To claim the deduction, you will need to get Form 1098-E from your lender or loan servicer

STEP 6

Know that educational benefits from your employer may be tax free.

If you have a generous employer, you might be able to receive up to $5,250 a year of tax-free educational assistance benefits. This means that you may not have to pay tax on amounts your employer pays for your education, including payments for tuition, fees and similar expenses, books, supplies and equipment. The funds can be used for both undergraduate and graduate-level courses that do not have to be work related. However, you cannot use any of the tax-free education expenses paid for by your employer as the basis for any other deduction or credit, including the Hope and Lifetime Learning credits.

STEP 7

Cash in your government bonds tax free.

If you cashed in a government savings bond to pay for qualified educational expenses, you may be able to exclude the interest earned from your federal income taxes. The key is that you must have purchased a series EE bond issued after 1989 or the series I bond. The bond must be issued either in your name or in the name of both you and your spouse. You must have been at least 24 years old at the time that you purchased the bond, and it cannot have been a gift to your child or be in his or her name.

If you meet these requirements and your modified adjusted gross income is less than $63,100 if filing a single return or $94,700 if filing a joint return, you can deduct the interest used to pay for tuition. If your modified gross income is higher than these amounts but below $78,100 for single filers and $124,700 for joint filers, then you will still be able to exclude a portion of the interest. You will need to file Form 8815 to calculate your education savings bond interest exclusio

STEP 8

Understand the money-saving tax benefits of scholarships.

One big benefit of scholarships is that they are tax free! Academic scholarships or fellowships that are used for qualified tuition, fees and books are generally not taxable. For a scholarship or fellowship to be non-taxable, you must meet the following conditions:

- You are a candidate for a degree at an educational institution;
- The amounts you receive as a scholarship or fellowship must be used for tuition and fees required for enrollment or attendance at the educational institution, or for books, supplies and equipment required for courses of instruction; and
- The amounts received are not a payment for your services.

You cannot exclude any scholarships or grants that are used to pay for room and board from your taxable income.

Lower your income to claim a tax credit.

If you are over the income limits that trigger a phase-out for any tax break, you may be able to change your modified adjusted gross income just enough to qualify for a full credit or a larger partial credit. The key is to boost your "above the line" contributions. If you look at your 1040 tax return, you'll notice that your adjusted gross income is on line 37. Anything that appears on lines 23 through 36 are known as "above the line" deductions, which will reduce your AGI. For most people, the one item over which they have the most control is their contribution to IRAs, including SEP and SIMPLE IRAs. Also, contributions to 401k, 403b or 457 retirement plans reduce the income reported on a W2 and have the same effect of reducing the AGI. By increasing your contributions to these accounts, you will lower your adjusted gross income. This might be enough to give you a bigger slice of the tax break pie. Plus, money in your retirement accounts is sheltered from the financial aid calculations, which can increase your chances of getting more financial aid from the college.

Get more tax help.

Tax questions are never easy to answer and it is essential that you talk to a professional accountant. In addition, tax laws are constantly changing. To get the latest (and free) information, surf over to the IRS website at http://www.irs.gov or schedule a phone or personal appointment. You can call 800-829-1040 with questions, or try the IRS's Everyday Tax Solutions service by calling your local IRS office to set up an in-person appointment. If you have access to TTY/TDD equipment, call 800-829-4059.

Final Thoughts ...

Paying for college is all about saving as much money as you can, whenever and wherever you can. Avoiding or reducing taxes is certainly one way to do so. It may not be a windfall, but again, every little bit counts. So while every year we dread the arrival of tax day at least when it comes to paying for education, there is good news. Every dollar that we save probably will go directly to the college, but most families would agree that they would much rather pay the tuition collector than the tax collector.