

## Tax Strategies for Financing Education

Traditionally, formal long-term tax planning has been directed toward creating an estate and providing assets for retirement income with a minimum of taxable consequences. With escalating educational costs and a variety of options available for financing the education of children, educational tax planning has become increasingly important.

### Available Tax Credits and Deductions

**Tax Credits.** Congress created two tax credits for taxpayers with education costs the **Hope Tax Credit** and the **Lifetime Learning Credit**. However, these credits are not available to higher income taxpayers. They are phased-out between \$43,000 and \$53,000 of modified adjusted gross income (MAGI) for single taxpayers and between \$87,000 and \$107,000 of MAGI for married couples filing jointly. Both education credits are nonrefundable and cannot exceed a taxpayer's tax liability. An eligible student may be the taxpayer, the taxpayer's spouse or a dependent for whom the taxpayer claims a dependency exemption. Qualified educational expenses are out-of-pocket costs for tuition and fees required for enrollment or attendance. Books, supplies and equipment do not qualify unless they are a condition of enrollment. Room and Board, insurance, and similar personal and living expenses also do not qualify.



**The Hope Tax Credit** provides for a tax deduction of 100% of the first \$1,000 paid for tuition and qualified educational expenses during the tax year and 50% of the next \$1,000. If there is more than one student in the family the maximum of \$1,500 can be taken for each student. The student must carry at least half the normal full-time workload as required by the institution. The Hope tax credit only applies to the first two years of the student's post-secondary education at an eligible educational institution.

**The Lifetime Learning Credit** is \$2,000 per year per taxpayer (20% of up to \$10,000 of qualified educational expenses). The credit can be claimed even if the student is enrolled on less than a halftime basis. Also, eligible courses include those that are part of obtaining a degree to acquire or improve job skills. The credit is not limited to students in the first two years of post-secondary education.

**Tuition and Fees Deduction.** As an alternative to the above tax

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**(EDUCATION continued)**

credits, a deduction of up to \$4,000 is available for qualified tuition and required enrollment fees. The deduction is above the line, which means that it can be taken whether or not the taxpayer itemizes deductions. A benefit of the tuition and fees deduction is that it has a higher income limitation than the credits. A partial deduction is allowed for MAGI of up to \$80,000 for single taxpayers and \$160,000 for married couples filing jointly. However, the deduction expires after 2005, and will not be available thereafter unless Congress extends the provision.

A number of tax planning opportunities exist for those incurring tuition costs. The deduction and credits can all be claimed if there are different qualified students for each category. Taxpayers who are eligible for either of the credits or the deduction should consider which gives them the highest overall tax savings. Additionally, a planning opportunity exists for a parent to forego the dependency deduction for a student in order for that student to claim one of the credits, sometimes lowering the family's overall tax burden.

**Deducting Interest on Qualified Education Loans.** Interest due and paid on qualified education loans for "qualified higher education expenses" can also be deducted "above the line." The maximum amount of interest a taxpayer is allowed to deduct is \$2,500, and this amount is reduced ratably if AGI is above \$105,000 for married joint filers and \$50,000 for single and head of household filers.

Qualified Higher Education Expenses for purposes of deducting interest on student loans are the student's cost of attending the educational institution, including tuition, fees, room and board, books, equipment and related expenses.

### **Financing Higher Education**

#### **Gift Tax Exclusion for Tuition**

**Payments.** Taxpayers incur no gift tax consequences when the total gifts made to a recipient during a year are no more than the annual gift tax exclusion. Transfers to a student or another individual for purposes of paying educational costs are treated as gifts subject to the annual gift tax exclusion. However, tuition payments made directly to an educational institution on a recipient's behalf are an exclusion under the gift tax rules and can be made in addition to amounts gifted under the annual exclusion. This allows a good planning opportunity for grandparents (or any other family member), removing assets from their taxable estates for a grandchild's education without incurring any transfer tax consequences.

#### **Using Traditional or Roth IRA**

**Withdrawals.** A taxpayer may make withdrawals from a traditional or Roth IRA to pay the qualified higher education expenses for the taxpayer; spouse; or the children, stepchildren, or grandchildren of the taxpayer or taxpayer's spouse at an eligible educational institution without incurring the 10% early withdrawal penalty. However, if the withdrawal is from a traditional IRA the taxpayer will owe federal income tax on the amount withdrawn. Taxpayers may make tax-free withdrawals from the contributions

*A number of tax planning opportunities exist for those incurring tuition costs.*

to a Roth IRA as an additional source of college education funds. Once a taxpayer turns age 59 1/2, earnings from a Roth IRA can also be withdrawn tax-free, if the account has been open at least five years.

**Shifting Assets and Income to Maximize College Funds.** Funds can be transferred to children to be used to pay their education costs. Property can be gifted to a child under the Uniform Gifts to Minors Act (UGMA) or the Uniform Transfers to Minors Act (UTMA), as well as to trusts directed to pay the educational costs. Additionally, a child can be employed in a family business, using the income they earn to pay for education costs.

**UGMA or UTMA** funds can be used to pay a child's college education expenses. The custodian, who can be a parent, holds the property for the child's benefit. The custodian must distribute the assets to the minor when they reach the age of majority (18-21 depending upon state law). This is a major disadvantage of these accounts, as the assets pass directly to the child's control at the age of majority and can thus be used by the child for any purpose, not limited to college financing. Also, they are considered the child's assets for purposes of determining college financial aid. A child's assets reduce the qualification for financial aid much more than assets considered owned by a parent.

For income tax purposes, income earned on UGMA/UTMA accounts is taxable to the child. If the child is under 14 years of age, income that exceeds

\$1,600 is taxed at the parents tax rate, not the lower rate that would have applied for the child. However, once the child has reached the age of 14, appreciated assets (i.e. marketable securities) can be transferred to the child's UGMA/UTMA account and then sold, taking advantage of the child's lower tax rate.

Certain trusts are also possible tools in education planning. The advantage in using a trust is that it can restrict the child's access to the money until age 21, or beyond. However, the trust income tax structure not only curtails the over-all tax savings, but essentially penalizes trusts that accumulate income.

(To be continued in the next issue)

---Robert B. McMunigle, CPA, PFS

Editor's Note --- Bob is a Manager in the Firm's Meadville Office. He specializes in business valuation and litigation services in all aspects of tax planning. Bob is accredited by the AICPA as a Personal Financial Specialist



*Taxpayers may make tax-free withdrawals from the contributions to a Roth IRA as an additional source of college education funds.*

# DEPRECIATION: MAXIMIZING ITS BENEFITS

## Section 179 Depreciation

Depreciation is an important element in reducing the taxable income of a business. Although the temporary bonus depreciation is no longer applicable, accelerated depreciation under Section 179 remains available. Section 179 allows you to deduct the entire cost of a qualified asset in the year it was acquired. In 2006, a business can deduct \$108,000. This limit will also be adjusted for inflation in 2007. Unfortunately, in 2008 the limit of this deduction will revert to \$25,000.

In Pennsylvania, the maximum allowable deduction for personal income taxes (Schedule C, Partnership returns, & S corporations) is \$25,000.

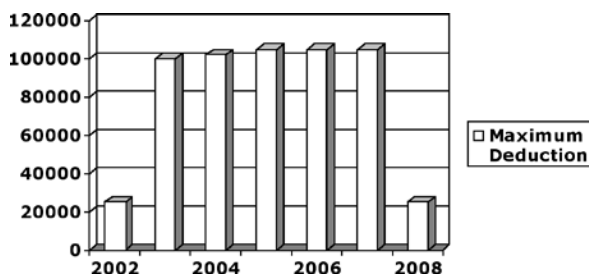


Figure 1 – Maximum Allowable Deduction

## Limitations on the cost of Property

The maximum allowable deduction is reduced by the amount over a limit on the cost of the property. Before 2003, this limit was \$200,000. In 2006, it will be \$430,000. If the cost of your qualifying Section 179 property is more than \$430,000, you must deduct the amount over \$430,000 from the deduction limit. For example, if the cost of the property to be depreciated

was \$482,000, it would be \$52,000 over the limit. The deduction limit of \$108,000 would be reduced by \$52,000 to \$56,000. If the cost is \$538,000 or more, you cannot take a Section 179 deduction.

To qualify for Section 179 depreciation

- It must be eligible property.
- It must be acquired for business use (used more than 50% business).
- It must have been acquired by purchase.
- It can be used property, as well as new property.

## What Property is Qualifying?

Qualifying property is

- Tangible personal property including machinery and equipment.
- Other tangible property (except for buildings and their structural components) that is an integral part of manufacturing, production or extraction.
- A research facility used in connection with manufacturing, production or extraction.
- A facility used in connection with manufacturing, production or extraction for the bulk storage of fungible commodities.
- Off-the-shelf computer software if it is readily available for purchase by the general public, is subject to a non-exclusive license and has not been substantially modified. Databases that are not in the public domain, do not qualify.

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## Eligible Property Must Have a Business Use

To be eligible the property must have been acquired for business use. Certain property does not qualify. These include investment property, rental property and property that produces royalties.

If the property is used both for business and non-business purposes, its business use must exceed 50% of its total use. The deduction is calculated by multiplying the percentage of business use by the cost. For example, if the property cost \$100,000 and 75% of its use is for business purposes, \$75,000 of the cost is eligible for depreciation.

## Eligible Property Must be Purchased

Property is not considered to be acquired by purchase if:

- It is acquired by one member of a controlled group from another member of the group.
- It is a gift or inheritance.
- It is acquired from a related person.

## What is not Eligible Property?

Land and improvements such as buildings and other permanent structures and their components are real property, not personal property and are not qualified as Section 179 property.

Generally, you cannot claim a Section 179 deduction on leased property unless it is property that you manufacture or purchase and lease to someone else.

The term of the lease must be less than 50% of the property's useful life.

The deductions that you are allowed on the property cannot be more than 15% of the rental income from the property.

If you buy qualifying property with cash and a trade-in, only the cash portion of the purchase is eligible to be used for the Section 179 deduction.

## Other Limitations

Although the total amount that you can deduct for Section 179 in 2006 is \$108,000, this amount can be allocated among several qualifying items and you do not have to claim the full \$108,000.

The total Section 179 deduction cannot exceed the taxable income from the business. Any cost not deductible because of the income limitation can be carried over into the following year. Taxable income must be calculated without regard to:

- The Section 179 deduction
- The self-employment tax deduction
- Any net operating loss carry back or carry forward
- Any unreimbursed employee business expenses

If the business use of the property drops below 50% in any year, you must recapture the deductions made on that property. The recapture is treated as income, but the recapture amount is added to the basis of that property for future depreciation.

---Joseph C. Paparone II, CPA

Editor's note ---Joe is a Partner in the Grove City Office. A significant and growing portion of his practice is privately-held companies, many family-owned.



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