



Department of the Treasury
Internal Revenue Service

Publication 970

Cat. No. 25221V

Tax Benefits for Education

For use in preparing
2002 Returns



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Contents

Important Changes for 2002	2
Important Changes for 2003	3
Important Reminder	3
Introduction	3
1. Hope Credit	5
Can You Claim the Credit?	5
What Expenses Qualify?	6
Who Is an Eligible Student?	7
Who Can Claim a Dependent's Expenses?	9
How Is the Credit Figured?	9
How Is the Credit Claimed?	10
When Must the Credit Be Repaid (Recaptured)?	10
Illustrated Example	10
2. Lifetime Learning Credit	12
Can You Claim the Credit?	12
What Expenses Qualify?	13
Who Is an Eligible Student?	14
Who Can Claim a Dependent's Expenses?	14
How Is the Credit Figured?	15
How Is the Credit Claimed?	15
When Must the Credit Be Repaid (Recaptured)?	16
Illustrated Example	16
3. Student Loans	18
Student Loan Interest Deduction	18
Canceled Student Loan	22
4. Tuition and Fees Deduction	24
Can You Take the Deduction?	24
What Expenses Qualify?	24
Who Is an Eligible Student?	26
Who Can Claim a Dependent's Expenses?	26
How Is the Deduction Figured?	27
How Is the Deduction Claimed?	28
5. Coverdell Education Savings Account (ESA) — Formerly Education IRA	29
What Is a Coverdell ESA?	30
Contributions	31
Rollovers and Other Transfers	33
Withdrawals	34
6. Qualified Tuition Program (QTP)	40
What Is a Qualified Tuition Program?	41
How Much Can You Contribute?	41
Are Distributions Taxable?	41
Can You Transfer Amounts or Change Beneficiaries?	43
7. Early Withdrawals From IRAs	44
Who Can Make Early Withdrawals Free of the 10% Tax?	44
How Do You Figure the Amount Not Subject to the 10% Tax?	44
8. Education Savings Bond Program	46
Who Can Cash In Bonds Tax Free?	46
How Is the Tax-Free Amount Figured?	47

9. Employer-Provided Educational Assistance	50
10. How To Get Tax Help	51
Appendices	53
Appendix A—Illustrated Example	53
Appendix B—Highlights of Tax Benefits	55
Index	56

Important Changes for 2002

Hope and lifetime learning credits. Beginning in 2002:

- You may be able to claim an education credit in the same year in which you receive a distribution from a Coverdell education savings account (ESA) or a qualified tuition program (QTP). However, you cannot use the same expenses to figure both the credit and the taxable portion of a Coverdell ESA or a QTP distribution.
- The amount of your education credit is gradually reduced (phased out) if your modified adjusted gross income (MAGI) is between \$41,000 and \$51,000 (\$82,000 and \$102,000 if you file a joint return). You cannot claim a credit if your MAGI is \$51,000 or more (\$102,000 or more if you file a joint return). This is an increase from the 2001 limits of \$40,000 and \$50,000 (\$80,000 and \$100,000 if filing a joint return).

For more information about the Hope and lifetime learning credits, see chapters 1 and 2.

Student loan interest deduction. Beginning in 2002:

- All student loan interest payments you make on or after January 1, 2002, may be deductible. You are no longer limited to deducting interest paid only during the first 60 months that interest payments are required.
- The amount of your deduction will be phased out (gradually reduced) if your modified adjusted gross income (MAGI) is between \$50,000 and \$65,000 (\$100,000 and \$130,000 if you file a joint return). You will not be able to take a deduction if your MAGI is \$65,000 or more (\$130,000 or more if you file a joint return). This is an increase from the 2001 limits of \$40,000 and \$55,000 (\$60,000 and \$75,000 if filing a joint return).

See chapter 3 for more information about the student loan interest deduction.

Tuition and fees deduction. Another education benefit has been added for tax years 2002 through 2005. Beginning in 2002, you may be able to deduct the cost of higher education for yourself, your spouse, or a dependent, even if you do not itemize deductions on Schedule A, Form 1040. For more information, see chapter 4.

Coverdell education savings account (ESA). Beginning in 2002:

- The most you can contribute each year to a Coverdell ESA is increased from \$500 to \$2,000.

- If you are married and filing a joint return, your contribution limit is not reduced if your modified adjusted gross income (MAGI) is \$190,000 or less. Your contribution limit is gradually reduced (phased out) if your MAGI is more than \$190,000 but less than \$220,000. If your MAGI is \$220,000 or more, you cannot contribute to a Coverdell ESA. This is an increase from the 2001 limits of \$150,000 and \$160,000.

- The final date on which you can make contributions to a Coverdell ESA for any year has been extended from the end of that year to the due date of your return for that year (not including extensions).

- In addition to higher education expenses, qualified education expenses include certain elementary and secondary education expenses. Also included are the expenses necessary for a special needs beneficiary to enroll in or attend an eligible institution.

- The limit on the amount that is considered reasonable for room and board expenses has been changed. You must contact the educational institution for its qualified room and board costs.

- Age limitations are waived for special needs beneficiaries. You can make contributions to a Coverdell ESA for a special needs beneficiary after his or her 18th birthday. Also, you can leave assets in a Coverdell ESA set up for a special needs beneficiary after the beneficiary reaches age 30.

- You can claim the Hope or lifetime learning credit in the same year you take a tax-free withdrawal from a Coverdell ESA, provided that the distribution from your ESA is not used for the same expenses for which a credit is claimed.

- For purposes of rollovers and changes of beneficiaries, the definition of family member is expanded to include first cousins of the designated beneficiary.

- You can make contributions to a Coverdell ESA and a qualified tuition program (QTP) in the same year for the same beneficiary.

For more information about Coverdell ESAs, see chapter 5.

Qualified tuition program (QTP). Beginning in 2002:

- Qualified state tuition programs (QSTPs) are renamed qualified tuition programs (QTPs).
- A distribution from a QTP established and maintained by a state (or an agency or instrumentality of the state) can be excluded from your income if the amount distributed is used for qualified higher education expenses.
- You can make contributions to a QTP established and maintained by one or more eligible educational institutions. However, earnings on the account will be taxable if withdrawn before January 1, 2004. The 10% additional tax will not be assessed on taxable earnings that are used for the qualified higher education expenses of the designated beneficiary.
- Amounts in a QTP can be rolled over, tax free, to another QTP for the same beneficiary. However,

such a rollover cannot apply to more than one transfer within any 12-month period.

- For purposes of rollovers and changes of designated beneficiaries, the definition of family members is expanded to include first cousins of the beneficiary.
- The limit on the amount that is considered reasonable for room and board expenses has been changed. You must contact the educational institution for its qualified room and board costs.
- The definition of qualified higher education expenses has been expanded to include expenses of a special needs beneficiary necessary for that person's enrollment or attendance at an eligible educational institution.
- You can claim the Hope or lifetime learning credit in the same year you receive a tax-free distribution from a QTP if the distribution is not used for the same expenses for which the credit is claimed.
- QTP earnings that are taxable only because an education credit was claimed are not subject to the 10% additional tax on taxable withdrawals.
- You can make contributions to a Coverdell ESA and a QTP in the same year for the same beneficiary.

For more information about qualified tuition programs, see chapter 6.

Early withdrawals from IRAs. Beginning in 2002:

- The definition of qualified higher education expenses has been expanded to include certain expenses for special needs students.
- The limit on the amount that is considered reasonable for room and board expenses has been changed. You must contact the educational institution for its qualified room and board costs.

See chapter 7 for more information.

Education savings bond program. The amount of your interest exclusion for 2002 will be phased out (gradually reduced) if your modified adjusted gross income (MAGI) is between \$57,600 and \$72,600 (\$86,400 and \$116,400 if you file a joint return). You will not be able to exclude any interest if your MAGI is \$72,600 or more (\$116,400 or more if you file a joint return). This is an increase from the 2001 limits of \$55,750 and \$70,750 (\$83,650 and \$113,650 if filing a joint return). For more information on this program, see chapter 8.

Employer-provided educational assistance. The tax-free status of up to \$5,250 of employer-provided educational assistance benefits each year has been extended through 2010. Beginning in 2002, it applies to both undergraduate- and graduate-level courses. See chapter 9 for more information.

Important Changes for 2003

Lifetime learning credit. Beginning in 2003, the amount of qualified tuition and related expenses you may take into

account in figuring your lifetime learning credit increases from \$5,000 to \$10,000. The credit will equal 20% of these qualified expenses, with the maximum credit being \$2,000.

Student loan interest deduction. Beginning in 2003, the income ranges for phasing out the student loan interest deduction may be adjusted annually for inflation.

Coverdell education savings account (ESA). There will be no excise tax on excess contributions if the excess (and earnings on that amount) is withdrawn before the beginning of the sixth month following the year of the contribution. Generally, a calendar year taxpayer will have until May 31, 2003, to withdraw an excess contribution for 2002.

Important Reminder

Photographs of missing children. The Internal Revenue Service is a proud partner with the National Center for Missing and Exploited Children. Photographs of missing children selected by the Center may appear in this publication on pages that would otherwise be blank. You can help bring these children home by looking at the photographs and calling **1-800-THE-LOST (1-800-843-5678)** if you recognize a child.

Introduction

This publication explains tax benefits that may be available to you if you are saving for or paying higher education costs for yourself or another student.

What is in this publication. Two tax credits for which you may be eligible are explained in chapters 1 and 2. These benefits, which reduce the amount of your income tax, are:

- The Hope credit, and
- The lifetime learning credit.

Eight other types of benefits are explained in chapters 3 through 9. With these benefits, you may be able to:

- Deduct student loan interest,
- Receive tax-free treatment of canceled student loans,
- Deduct tuition and fees for higher education,
- Establish and contribute to a Coverdell education savings account (ESA), which features tax-free earnings,
- Participate in a qualified tuition program (QTP).
- Make early withdrawals from any type of individual retirement arrangement (IRA) for education costs without paying the 10% additional tax,
- Cash in savings bonds for education costs without having to pay tax on the interest, and
- Receive tax-free educational benefits from your employer.

Note. You generally cannot claim more than one of the benefits described in the lists above for the same qualifying education expense.

Comparison table. Some of the features of each of these benefits are highlighted in *Appendix B* on page 55 of this publication. This general comparison table may guide you in determining which benefits you may be eligible for and which chapters you may want to read.

Analyzing your tax withholding. After you estimate your education tax benefits for the year, you may be able to reduce the amount of your federal income tax withholding. Also, you may want to recheck your withholding during the year if your personal or financial situation changes. See Publication 919, *How Do I Adjust My Tax Withholding*, for more information.

What is not in this publication. Some educational benefits are not covered in this publication.

IF you need information on...	THEN see...
work-related education expenses that you claim as an itemized deduction	Publication 508, <i>Tax Benefits for Work-Related Education</i> .
scholarships that you may be able to exclude from income	Publication 520, <i>Scholarships and Fellowships</i> .

Comments and suggestions. We welcome your comments about this publication and your suggestions for future editions.

You can e-mail us while visiting our web site at www.irs.gov.

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We respond to many letters by telephone. Therefore, it would be helpful if you would include your daytime phone number, including the area code, in your correspondence.

Useful Items

You may want to see:

Publication

- 508** Tax Benefits for Work-Related Education
- 520** Scholarships and Fellowships
- 525** Taxable and Nontaxable Income
- 550** Investment Income and Expenses
- 553** Highlights of 2002 Tax Changes
- 590** Individual Retirement Arrangements (IRAs)

Form (and Instructions)

- 1040** U.S. Individual Income Tax Return
- 1040A** U.S. Individual Income Tax Return
- 5329** Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts
- 8815** Exclusion of Interest From Series EE and I U.S. Savings Bonds Issued After 1989
- 8863** Education Credits (Hope and Lifetime Learning Credits)

See chapter 10, *How To Get Tax Help*, for information about getting these publications and forms.

1.

Hope Credit

Important Changes for 2002

Hope credit and distribution from Coverdell ESA or QTP. Beginning in 2002, you may be able to claim a Hope credit in the same year in which you receive a distribution from either a Coverdell education savings account (ESA), formerly called an education IRA, or a qualified tuition program (QTP). However, you cannot use the same expenses to figure both the Hope credit and the taxable portion of a Coverdell ESA or QTP distribution. See *No Double Benefit Allowed*, under *What Expenses Qualify*, later.

Income limits for credit reduction increased. For 2002, the amount of your Hope credit is gradually reduced if your modified adjusted gross income (MAGI) is between \$41,000 and \$51,000 (\$82,000 and \$102,000 if you file a joint return). You cannot claim a Hope credit if your MAGI is \$51,000 or more (\$102,000 or more if you file a joint return). This is an increase from the 2001 limits of \$40,000 and \$50,000 (\$80,000 and \$100,000 if filing a joint return). See *Does the Amount of Your Income Affect the Amount of Your Credit*, later, for more information.

Introduction

The Hope and lifetime learning credits may be available to you if you pay higher education costs.

The lifetime learning credit is discussed in chapter 2.

This chapter explains:

- Who can claim the Hope credit,
- What expenses qualify for the credit,
- Who is an eligible student,
- Who can claim a dependent's expenses,
- How the credit is figured,
- How the credit is claimed, and
- When the credit must be repaid.

What is the tax benefit of the Hope credit? You may be able to claim a Hope credit of up to \$1,500 for qualified tuition and related expenses paid for *each* eligible student.

A tax credit reduces the amount of income tax you may have to pay. Unlike a deduction, which reduces the amount of income subject to tax, a credit directly reduces the tax itself.

The Hope credit you are allowed may be limited by the amount of your income and the amount of your tax.

Can you claim both education tax credits this year? For each student, you can elect for any year only *one* of the credits. For example, if you elect to take the Hope credit for a child on your 2002 tax return, you cannot, for

that same child, also claim the lifetime learning credit for 2002.

Tax credit for one student. You can claim the Hope credit for a year based on the tuition and expenses of a student only if that student has not completed the first 2 years of postsecondary education (generally the freshman and sophomore years) at an eligible educational institution before the beginning of that year. Although it may take longer than 2 calendar years for a student to complete the freshman and sophomore years, you cannot claim the Hope credit based on the tuition and expenses of the same student more than twice.

The lifetime learning credit is not subject to either of these limits. This credit, based on the tuition and expenses of a student, may be claimed regardless of the amount of postsecondary education the student has completed and for an unlimited number of years for the same student. If a student qualifies for both the Hope and the lifetime learning credits for the same year, you may claim either credit, but not both.

Tax credits for more than one student. If you pay qualified expenses for more than one student in the same year, you can choose to take credits on a per-student, per-year basis. This means that, for example, you can claim the Hope credit for one student and the lifetime learning credit for another student in the same year.

Table 1–1 summarizes the differences between the Hope and lifetime learning credits. In 2002, if you are eligible to claim both credits based on the qualified higher education expenses of one student, it will generally be to your benefit to claim the Hope credit.

Table 1–1. Comparison of Education Credits

Hope Credit	Lifetime Learning Credit
Up to \$1,500 credit per eligible student	Up to \$1,000 credit per return
Available ONLY until the first 2 years of postsecondary education are completed	Available for all years of postsecondary education and for courses to acquire or improve job skills
Available ONLY for 2 years per eligible student	Available for an unlimited number of years
Student must be pursuing an undergraduate degree or other recognized education credential	Student does not need to be pursuing a degree or other recognized educational credential
Student must be enrolled at least half time for at least one academic period beginning during the year	Available for one or more courses
No felony drug conviction on student's record	Felony drug conviction rule does not apply

Can You Claim the Credit?

The following rules will help you determine if you are eligible to claim the Hope credit on your tax return.

Who Cannot Claim the Credit?

You cannot claim the Hope credit if any of the following apply.

- Your filing status is married filing separately.
- You are listed as a dependent in the *Exemptions* section on another person's tax return (such as your parents'). See *Who Can Claim a Dependent's Expenses*, later.
- Your modified adjusted gross income is \$51,000 or more (\$102,000 or more in the case of a joint return). Modified adjusted gross income is explained later under *Does the Amount of Your Income Affect the Amount of Your Credit*.
- You (or your spouse) were a nonresident alien for any part of 2002 and the nonresident alien did not elect to be treated as a resident alien for tax purposes. More information on nonresident aliens can be found in Publication 519, *U.S. Tax Guide for Aliens*.
- You claim the lifetime learning credit for the same student in 2002.

Who Can Claim the Credit?

Generally, you can claim the Hope credit if **all three** of the following requirements are met.

- 1) You pay **qualified tuition and related expenses** of higher education.
- 2) You pay the tuition and related expenses for an **eligible student**.
- 3) The eligible student is either yourself, your spouse, or a **dependent for whom you claim an exemption** on your tax return.

Qualified tuition and related expenses are defined below under *What Expenses Qualify*. Eligible students are defined later under *Who Is an Eligible Student*.

What Expenses Qualify?

The Hope credit is based on qualified tuition and related expenses you pay for yourself, your spouse, or a dependent for whom you claim an exemption on your tax return. Generally, the credit is allowed for qualified tuition and related expenses paid in 2002 for an **academic period** beginning in 2002 or in the first 3 months of 2003.

For example, if you paid \$1,500 in December 2002 for qualified tuition for the Spring 2003 semester beginning in January 2003, you may be able to use that \$1,500 in figuring your 2002 credit.

Academic period. An academic period includes a semester, trimester, quarter, or other period of study (such as a summer school session) as reasonably determined by an educational institution.

Payments with borrowed funds. You can claim a Hope credit for qualified tuition and related expenses paid with the proceeds of a loan. You use the expenses to figure the Hope credit for the year in which the expenses are paid, not the year in which the loan is repaid.

Qualified Tuition and Related Expenses

In general, qualified tuition and related expenses are tuition and fees required for enrollment or attendance at an **eligible educational institution**.

Eligible educational institution. An eligible educational institution is any college, university, vocational school, or other postsecondary educational institution eligible to participate in a student aid program administered by the Department of Education. It includes virtually all accredited, public, nonprofit, and proprietary (privately owned profit-making) postsecondary institutions. The educational institution should be able to tell you if it is an eligible educational institution.

Related expenses. Student-activity fees and fees for course-related books, supplies, and equipment are included in qualified tuition and related expenses **only** if the fees must be paid **to the institution** as a condition of enrollment or attendance.

In the following examples, assume that each student is an eligible student at an eligible educational institution.

Example 1. Jackson is a sophomore in University V's degree program in dentistry. This year, in addition to tuition, he is required to pay a fee to the university for the rental of the dental equipment he will use in this program. Because the equipment rental fee must be paid to University V for enrollment and attendance, Jackson's equipment rental fee is a **qualified related expense**.

Example 2. Donna and Charles, both first-year students at College W, are required to have certain books and other reading materials to use in their mandatory first-year classes. The college has no policy about how students should obtain these materials, but any student who purchases them from College W's bookstore will receive a bill directly from the college. Charles bought his books from a friend, so what he paid for them is **not** a qualified expense. Donna bought hers at College W's bookstore. Although Donna paid College W directly for her first-year books and materials, her payment is **not** a qualified related expense because the books and materials are **not required** to be purchased from College W for enrollment or attendance at the institution.

Example 3. When Marci enrolled at College X for her freshman year, she had to pay a separate student activity fee in addition to her tuition. This activity fee is required of all students, and is used solely to fund on-campus organizations and activities run by students, such as the student newspaper and the student government. No portion of the fee covers personal expenses. Although labeled as a student activity fee, the fee is required for Marci's enrollment and attendance at College X. Therefore, it is a **qualified related expense**.

No Double Benefit Allowed

You cannot do any of the following.

- Deduct higher education expenses on your income tax return (as, for example, a business expense or a tuition and fees deduction) and also claim a Hope credit based on those same expenses.
- Claim a Hope credit and a lifetime learning credit based on the same qualified higher education expenses.
- Claim a Hope credit based on the same expenses used to figure the taxable portion of a Coverdell ESA or QTP distribution. See *Coordination With Hope and Lifetime Learning Credits* in chapter 5 (Coverdell ESA) and chapter 6 (QTP).
- Claim a credit based on expenses paid with tax-free scholarship, grant, or employer-provided educational assistance. See *Adjustments to Qualified Expenses*, next.

Adjustments to Qualified Expenses

If you pay qualified higher education expenses with certain **tax-free** funds, you cannot claim a credit for those amounts. You must reduce the qualified expenses by the amount of any tax-free educational assistance you received.

Tax-free educational assistance could include:

- Scholarships,
- Pell grants,
- Employer-provided educational assistance,
- Veterans' educational assistance, and
- Any other nontaxable payments (other than gifts, bequests, or inheritances) received for education expenses.

Do not reduce the qualified expenses by amounts paid with the student's:

- Earnings,
- Loans,
- Gifts,
- Inheritances, and
- Personal savings.

Also, do not reduce the qualified expenses by any scholarship reported as income on the student's return or any scholarship which, by its terms, cannot be applied to qualified tuition and related expenses.

Example 1. In 2002, Jackie paid \$3,000 for tuition and \$5,000 for room and board at University X. The university did not require her to pay any fees in addition to her tuition in order to enroll in or attend classes. To help pay these costs, she was awarded a \$2,000 scholarship and a \$4,000 student loan.

The scholarship is a qualified scholarship that is excludable from Jackie's income, and, for purposes of figuring an

education credit (either Hope or lifetime learning), she must first use it to reduce her tuition (her only "qualified expense"). The student loan is not considered "tax-free educational assistance," so she does not use it to reduce the qualified expenses. Therefore, Jackie is treated as having paid only \$1,000 in qualified expenses (\$3,000 tuition – \$2,000 scholarship) to University X in 2002.

Example 2. The facts are the same as in *Example 1*, except that Jackie reports her entire scholarship as income on her tax return. In this case, the scholarship is not treated as a qualified scholarship. Therefore, it is allocated to expenses other than qualified expenses. Jackie is treated as paying the entire \$3,000 tuition to University X with other funds and can figure her education credit on the entire \$3,000.

Refunds. Qualified tuition and related expenses do not include expenses for which you receive a refund. If you paid expenses in 2002, and you receive a refund of those expenses before you file your tax return for 2002, simply reduce the amount of the expenses paid by the amount of the refund received. If you receive the refund after you file your 2002 tax return, see *When Must the Credit Be Repaid (Recaptured)*, later.

Expenses That Do Not Qualify

Qualified tuition and related expenses do not include the cost of:

- Insurance,
- Medical expenses (including student health fees),
- Room and board,
- Transportation, or
- Similar personal, living, or family expenses.

This is true even if the fee must be paid to the institution as a condition of enrollment or attendance.

Qualified tuition and related expenses generally do not include expenses that relate to any course of instruction or other education that involves sports, games or hobbies, or any noncredit course. However, if the course of instruction or other education is part of the student's degree program, these expenses can qualify.

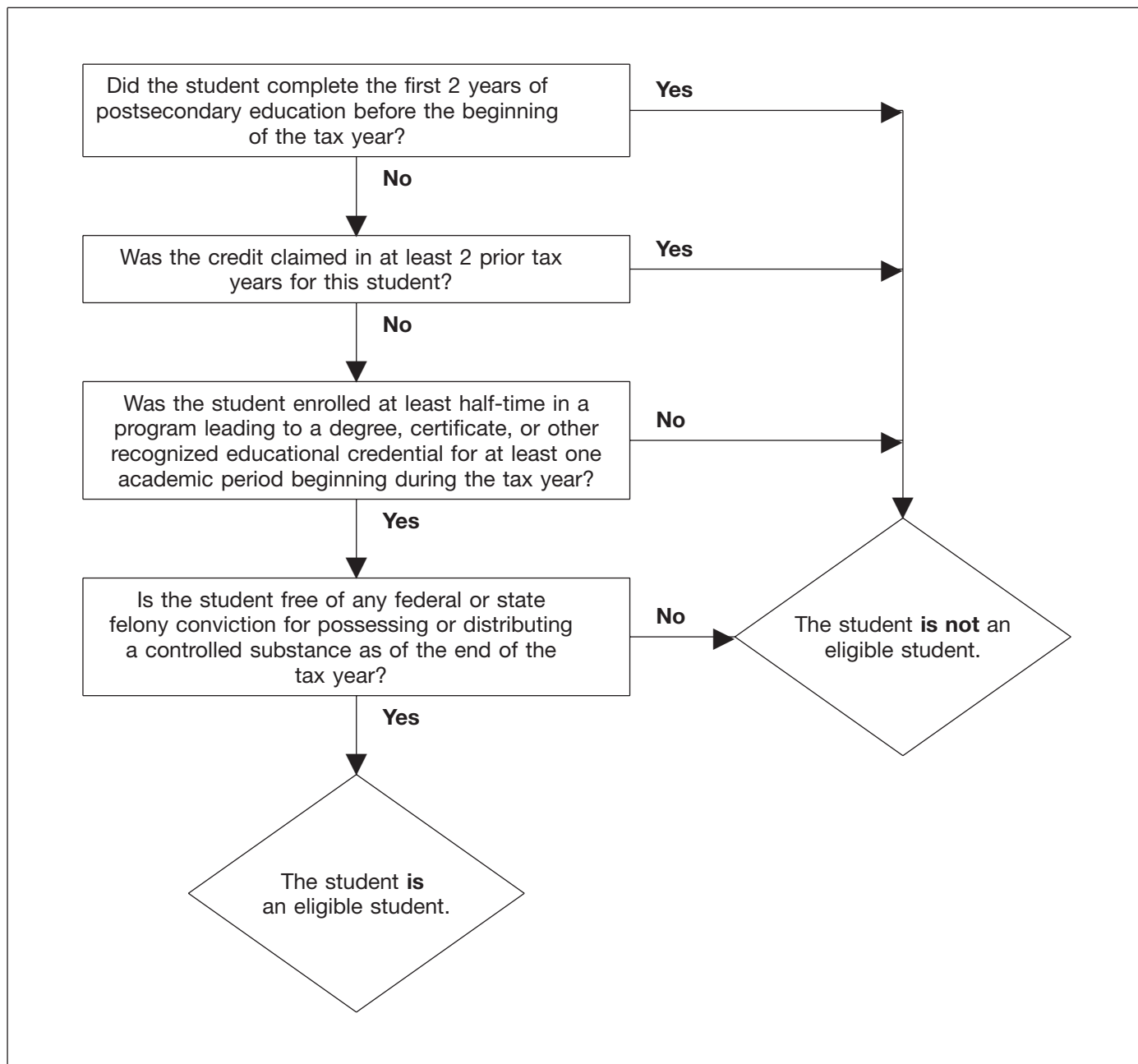
Who Is an Eligible Student?

To claim the Hope credit, the student for whom you pay qualified tuition and related expenses must be an **eligible** student. This is a student who meets **all** of the following requirements.

- 1) Did not have expenses that were used to figure a Hope credit in any 2 earlier tax years.
- 2) Had not **completed the first 2 years** of postsecondary education (generally, the freshman and sophomore years of college) before 2002.
- 3) Was **enrolled at least half-time** in a program that leads to a degree, certificate, or other recognized

Figure 1–1. Who Is an Eligible Student?

This chart is provided to help you quickly decide whether a student is eligible for the Hope credit. See the text for greater details.



educational credential for at least one **academic period** beginning in 2002.

- 4) Was free of any federal or state felony conviction for possessing or distributing a controlled substance as of the end of 2002.

These requirements are also shown in *Figure 1–1*.

Completion of first 2 years. A student who was awarded 2 years of academic credit for postsecondary work completed before 2002 has completed the first 2 years of postsecondary education. This student would not be an eligible student for purposes of the Hope credit.

Any academic credit awarded solely on the basis of the student's performance on proficiency examinations is disregarded in determining whether the student has completed 2 years of postsecondary education.

Enrolled at least half-time. A student was enrolled at least half-time if the student was taking at least half the normal full-time work load for his or her course of study.

The standard for what is half of the normal full-time work load is determined by each eligible educational institution. However, the standard may not be lower than those established by the Department of Education under the Higher Education Act of 1965.

Who Can Claim a Dependent's Expenses?

If there are qualified higher education costs for your dependent for a year, either you or your dependent, but not both of you, can claim a Hope credit for that dependent's expenses for that year.

For you to claim a Hope credit for your dependent's expenses, you must also claim an exemption for that person. You do this by listing his or her name and other required information on line 6c, Form 1040 (or Form 1040A).

IF you...	THEN only...
claim an exemption on your tax return for a dependent who is an eligible student	you can claim the Hope credit based on that student's expenses. The student cannot claim the credit.
do not claim an exemption on your tax return for a dependent who is an eligible student (even if entitled to the exemption)	the student can claim the Hope credit. You cannot claim the credit based on this student's expenses.

Expenses paid by dependent. If you claim an exemption on your tax return for an eligible student who is your dependent, treat any expenses paid by the student as if you had paid them. Include these expenses when figuring the amount of your Hope credit.



Qualified tuition and related expenses paid directly to an eligible educational institution for your dependent under a court-approved divorce decree are treated as paid by your dependent.

Expenses paid by others. If someone other than you, your spouse, or your dependent (such as a relative or former spouse) makes a payment directly to an eligible educational institution to pay for an eligible student's qualified tuition and related expenses, the student is treated as receiving the payment from the other person. The student is treated as paying the qualified tuition and related expenses to the institution. If you claim an exemption on your tax return for the student, you are considered to have paid the expenses.

Example. Ms. Allen makes a payment directly to an eligible educational institution in 2002 for her grandson Todd's qualified tuition and related expenses. For purposes of claiming a Hope credit, Todd is treated as receiving the money as a gift from his grandmother and, in turn, paying his qualified tuition and related expenses himself.

Unless an exemption for Todd is claimed on someone else's return, only Todd can use the payment to claim a Hope credit.

If anyone, such as Todd's parents, claims an exemption for Todd on his or her tax return, whoever claims the exemption may be able to use the expenses to claim a

Hope credit. If anyone else claims an exemption for Todd, Todd cannot claim a Hope credit.

How Is the Credit Figured?

The amount of the Hope credit (per eligible student) is the sum of:

- 1) 100% of the first \$1,000 of qualified tuition and related expenses you paid for the eligible student, **and**
- 2) 50% of the next \$1,000 of qualified tuition and related expenses you paid for that student.

The maximum amount of Hope credit you can claim in 2002 is \$1,500 times the number of eligible students. You can claim the full \$1,500 for each eligible student for whom you paid at least \$2,000 of qualified expenses. However, the credit may be reduced based on your modified adjusted gross income (MAGI). See *Does the Amount of Your Income Affect the Amount of Your Credit*, below.

Example. Jon and Karen Frost are married and file a joint tax return. For 2002, they claim an exemption for their dependent daughter on their tax return. Their MAGI is \$70,000. Their daughter is in her sophomore (second) year of studies at the local university. Jon and Karen paid qualified tuition and related expenses of \$4,300 in 2002.

Jon and Karen, their daughter, and the local university meet all of the requirements for the Hope credit. Jon and Karen can claim a \$1,500 Hope credit in 2002. This is 100% of the first \$1,000 of qualified tuition and related expenses, plus 50% of the next \$1,000.

Does the Amount of Your Income Affect the Amount of Your Credit?

The amount of your Hope credit is phased out (gradually reduced) if your MAGI is between \$41,000 and \$51,000 (\$82,000 and \$102,000 if you file a joint return). You cannot claim a Hope credit if your MAGI is \$51,000 or more (\$102,000 or more if you file a joint return).

Modified adjusted gross income (MAGI). For most taxpayers, MAGI is adjusted gross income (AGI) as figured on their federal income tax return.

MAGI when using Form 1040A. If you file Form 1040A, your MAGI is the AGI on line 22 of that form.

MAGI when using Form 1040. If you file Form 1040, your MAGI is the AGI on line 36 of that form, modified by adding back any:

- 1) Foreign earned income exclusion,
- 2) Foreign housing exclusion,
- 3) Exclusion of income for bona fide residents of American Samoa, and
- 4) Exclusion of income from Puerto Rico.

You can use *Worksheet 1-1* (see next page) to figure your MAGI.

Worksheet 1–1. **MAGI for the Hope Credit**

1. Enter your adjusted gross income (Form 1040, line 36)	1. _____
2. Enter your foreign earned income exclusion and/or housing exclusion (Form 2555, line 43, or Form 2555–EZ, line 18)	2. _____
3. Enter the amount of income from Puerto Rico that you are excluding	3. _____
4. Enter the amount of income from American Samoa that you are excluding (Form 4563, line 15)	4. _____
5. Add the amounts on lines 2, 3, and 4	5. _____
6. Add the amounts on lines 1 and 5. This is your modified adjusted gross income . Enter this amount on line 10 of your Form 8863	6. _____

Phaseout. The phaseout, if any, can be figured in Part III of Form 8863 or as shown in the following example.

Example. The information is the same as in the previous example for the Frosts, except that Jon and Karen have a MAGI of \$88,000.

They figure the total tentative Hope credit (100% of the first \$1,000 of qualified expenses, plus 50% of the next \$1,000 of qualified expenses). As shown in the previous example, the result is a \$1,500 total tentative credit.

To figure their allowable credit, they multiply the tentative credit (\$1,500) by a fraction. Because the Frosts are filing a joint return, the numerator of the fraction is \$102,000 (the upper limit) minus their MAGI. The denominator is \$20,000, which is the range of incomes for the phaseout (\$82,000 to \$102,000). The result is the amount of their Hope credit (\$1,050).

$$\$1,500 \times \frac{\$102,000 - \$88,000}{\$20,000} = \$1,050$$

How Is the Credit Claimed?

You claim the Hope credit by completing Parts I and III of **Form 8863** and submitting it with your Form 1040 or 1040A. Enter the credit on Form 1040, line 48, or Form 1040A, line 31. A filled-in Form 8863 is shown in the *Illustrated Example* at the end of this chapter.

An eligible educational institution (such as a college or university) that received payment of qualified tuition and related expenses in 2002 generally must issue **Form 1098–T, Tuition Payments Statement**, to each student by January 31, 2003. The information on Form 1098–T will help you determine whether you can claim an education tax credit for 2002. The eligible educational institution may ask for a completed **Form W–9S, Request for Student’s or Borrower’s Social Security Number and Certification**, or similar statement to obtain the student’s name, address, and taxpayer identification number.

When Must the Credit Be Repaid (Recaptured)?

If, after you file your 2002 tax return, you receive tax-free educational assistance for, or a refund of, an expense you used to figure a Hope credit on that return, you may have to repay all or part of the credit. You must refigure your Hope credit for 2002 as if the assistance or refund was received in 2002. Subtract the amount of the refigured credit from the amount of the credit you claimed. The result is the amount you must repay. You add the repayment (recapture) to your tax liability for the year you receive the assistance or refund (see the instructions for your tax return for that year). Your original 2002 tax return does not change.

Illustrated Example

Jim Grant, a single taxpayer, enrolled full-time at a local college to earn a degree in computer science. This is the first year of his postsecondary education. During 2002, he paid \$1,600 for his qualified 2002 tuition. He and the college meet all of the requirements for the Hope credit. Jim’s MAGI is \$32,000. His income tax liability, before credits, is \$3,345. He figures his credit of \$1,300 as shown on the Form 8863 on the next page.

Note. In *Appendix A* at the end of this publication there is an example illustrating the use of Form 8863 when both the Hope credit and the lifetime learning credit are claimed on the same tax return.

Education Credits (Hope and Lifetime Learning Credits)

▶ See instructions.
 ▶ Attach to Form 1040 or Form 1040A.

Name(s) shown on return: Jim Grant Your social security number: 000 00 111

Part I Hope Credit. Caution: *The Hope credit may be claimed for no more than 2 tax years for the same student.*

1	(a) Student's name (as shown on page 1 of your tax return) First name Last name	(b) Student's social security number (as shown on page 1 of your tax return)	(c) Qualified expenses (but do not enter more than \$2,000 for each student). See instructions	(d) Enter the smaller of the amount in column (c) or \$1,000	(e) Subtract column (d) from column (c)	(f) Enter one-half of the amount in column (e)	
	Jim Grant	000 00 111	1,600	1,000	600	300	
2	Add the amounts in columns (d) and (f)			1,000		300	
3	Tentative Hope credit. Add the amounts on line 2, columns (d) and (f). If you are claiming the lifetime learning credit, go to Part II; otherwise, go to Part III ▶					3	1,300

Part II Lifetime Learning Credit

4	(a) Student's name (as shown on page 1 of your tax return) First name Last name	(b) Student's social security number (as shown on page 1 of your tax return)	(c) Qualified expenses. See instructions
5	Add the amounts on line 4, column (c), and enter the total		5
6	Enter the smaller of line 5 or \$5,000		6
7	Tentative lifetime learning credit. Multiply line 6 by 20% (.20) and go to Part III ▶		7

Caution: You cannot take the Hope credit and the lifetime learning credit for the same student.

Part III Allowable Education Credits

8	Tentative education credits. Add lines 3 and 7		8	1,300
9	Enter: \$102,000 if married filing jointly; \$51,000 if single, head of household, or qualifying widow(er)		9	51,000
10	Enter the amount from Form 1040, line 36, or Form 1040A, line 22		10	32,000
11	Subtract line 10 from line 9. If line 10 is equal to or more than line 9, stop ; you cannot take any education credits		11	19,000
12	Enter: \$20,000 if married filing jointly; \$10,000 if single, head of household, or qualifying widow(er)		12	10,000
13	If line 11 is equal to or more than line 12, enter the amount from line 8 on line 14 and go to line 15. If line 11 is less than line 12, divide line 11 by line 12. Enter the result as a decimal (rounded to at least three places)		13	×
14	Multiply line 8 by line 13 ▶		14	1,300
15	Enter the amount from Form 1040, line 44, or Form 1040A, line 28		15	3,345
16	Enter the total, if any, of your credits from Form 1040, lines 45 through 47, or Form 1040A, lines 29 and 30		16	0
17	Subtract line 16 from line 15. If line 16 is equal to or more than line 15, stop ; you cannot take any education credits ▶		17	3,345
18	Education credits. Enter the smaller of line 14 or line 17 here and on Form 1040, line 48, or Form 1040A, line 31 ▶		18	1,300

*See Pub. 970 for the amount to enter if you are filing Form 2555, 2555-EZ, or 4563 or you are excluding income from Puerto Rico.

2.

Lifetime Learning Credit

Important Changes for 2002

Lifetime learning credit and distribution from Coverdell ESA or QTP. Beginning in 2002, you may be able to claim a lifetime learning credit in the same year in which you receive a distribution from either a Coverdell education savings account (ESA), formerly called an education IRA, or a qualified tuition program (QTP). However, you cannot use the same expenses to figure both the lifetime learning credit and the taxable portion of a Coverdell ESA or QTP distribution. See *No Double Benefit Allowed*, under *What Expenses Qualify*, later.

Income limits for credit reduction increased. For 2002, the amount of your lifetime learning credit is gradually reduced if your modified adjusted gross income (MAGI) is between \$41,000 and \$51,000 (\$82,000 and \$102,000 if you file a joint return). You cannot claim a Hope credit if your MAGI is \$51,000 or more (\$102,000 or more if you file a joint return). This is an increase from the 2001 limits of \$40,000 and \$50,000 (\$80,000 and \$100,000 if filing a joint return). See *Does the Amount of Your Income Affect the Amount of Your Credit*, later.

Important Change for 2003

Maximum lifetime learning credit increases to \$2,000. Beginning in 2003, the amount of qualified tuition and related expenses you may take into account in figuring your lifetime learning credit increases from \$5,000 to \$10,000. The credit will equal 20% of these qualified expenses, with the maximum credit being \$2,000.

Introduction

The Hope and lifetime learning credits may be available to you if you pay higher education costs.

The Hope credit is discussed in chapter 1.

This chapter explains:

- Who can claim the lifetime learning credit,
- What expenses qualify for the credit,
- Who is an eligible student,
- Who can claim a dependent's expenses,
- How the credit is figured,
- How the credit is claimed, and
- When the credit must be repaid.

What is the tax benefit of the lifetime learning credit?

You may be able to claim a lifetime learning credit of up to

\$1,000 for qualified tuition and related expenses paid for **all** students enrolled in eligible educational institutions. There is no limit on the number of years the lifetime learning credit can be claimed for each student.

A tax credit reduces the amount of income tax you may have to pay. Unlike a deduction, which reduces the amount of income subject to tax, a credit directly reduces the tax itself.

The lifetime learning credit you are allowed may be limited by the amount of your income and the amount of your tax.

Can you claim both education tax credits this year?

For each student, you can elect for any year only **one** of the credits. For example, if you elect to take the lifetime learning credit for a child on your 2002 tax return, you cannot, for that same child, also claim the Hope credit for 2002.

Tax credit for one student. You can claim the lifetime learning credit for any qualified expenses of a student's postsecondary education, including the following.

- Expenses for any year of postsecondary education.
- Expenses of courses taken to acquire or improve job skills, even if the courses are not part of a degree program.



If you are eligible to claim either the Hope or lifetime learning credit for a student, you can choose to claim either credit, but not both.

Tax credits for more than one student. If you pay qualified expenses for more than one student in the same year, you can choose to take credits on a per-student, per-year basis. This means that, for example, you can claim the Hope credit for one student and the lifetime learning credit for another student in the same year.

Table 2-1 (see next page) summarizes the differences between the lifetime learning and Hope credits. For 2002, if you are eligible to claim both credits based on the qualified higher education expenses of one student, it will generally be to your benefit to claim the Hope credit.

Can You Claim the Credit?

The following rules will help you determine if you are eligible to claim the lifetime learning credit on your tax return.

Who Cannot Claim the Credit?

You cannot claim the lifetime learning credit if **any** of the following apply.

- Your filing status is married filing separately.
- You are listed as a dependent in the *Exemptions* section on another person's tax return (such as your parents'). See *Who Can Claim a Dependent's Expenses*, later.

Table 2–1. **Comparison of Education Credits**

Lifetime Learning Credit	Hope Credit
Up to \$1,000 credit per return	Up to \$1,500 credit per eligible student
Available for all years of postsecondary education and for courses to acquire or improve job skills	Available ONLY until the first 2 years of postsecondary education are completed
Available for an unlimited number of years	Available ONLY for 2 years per eligible student
Student does not need to be pursuing a degree or other recognized educational credential	Student must be pursuing an undergraduate degree or other recognized educational credential
Available for one or more courses	Student must be enrolled at least half time for at least one academic period beginning during the year
Felony drug conviction rule does not apply	No felony drug conviction on student's record

- Your modified adjusted gross income is \$51,000 or more (\$102,000 or more in the case of a joint return). Modified adjusted gross income is explained later under *Does the Amount of Your Income Affect the Amount of Your Credit*.
- You (or your spouse) were a nonresident alien for any part of 2002 and the nonresident alien did not elect to be treated as a resident alien for tax purposes. More information on nonresident aliens can be found in Publication 519, *U.S. Tax Guide for Aliens*.
- You claim the Hope credit for the same student in 2002.

Who Can Claim the Credit?

Generally, you can claim the lifetime learning credit if **all three** of the following requirements are met.

- 1) You pay **qualified tuition and related expenses** of higher education.
- 2) You pay the tuition and related expenses for an **eligible student**.
- 3) The eligible student is either yourself, your spouse, or a **dependent for whom you claim an exemption** on your tax return.

Qualified tuition and related expenses are defined below under *What Expenses Qualify*. Eligible students are defined later under *Who Is an Eligible Student*.

What Expenses Qualify?

The lifetime learning credit is based on qualified tuition and related expenses you pay for yourself, your spouse, or a dependent for whom you claim an exemption on your tax

return. Generally, the credit is allowed for qualified tuition and related expenses paid in 2002 for an **academic period** beginning in 2002 or in the first 3 months of 2003.

For example, if you paid \$1,500 in December 2002 for qualified tuition for the Spring 2003 semester beginning in January 2003, you may be able to use that \$1,500 in figuring your 2002 credit.

Academic period. An academic period includes a semester, trimester, quarter, or other period of study (such as a summer school session) as reasonably determined by an educational institution.

Payments with borrowed funds. You can claim a lifetime learning credit for qualified tuition and related expenses paid with the proceeds of a loan. You use the expenses to figure the lifetime learning credit for the year in which the expenses are paid, not the year in which the loan is repaid.

Qualified Tuition and Related Expenses

In general, qualified tuition and related expenses are tuition and fees required for enrollment in a course at an **eligible educational institution**. The course must be either part of a postsecondary degree program or taken by the student to acquire or improve job skills.

Eligible educational institution. An eligible educational institution is any college, university, vocational school, or other postsecondary educational institution eligible to participate in a student aid program administered by the Department of Education. It includes virtually all accredited, public, nonprofit, and proprietary (privately owned profit-making) postsecondary institutions. The educational institution should be able to tell you if it is an eligible educational institution.

Related expenses. Student-activity fees and fees for course-related books, supplies, and equipment are included in qualified tuition and related expenses **only** if the fees must be paid **to the institution** as a condition of enrollment or attendance. For examples, see *Related expenses* in chapter 1 under *Qualified Tuition and Related Expenses*.

No Double Benefit Allowed

You cannot do any of the following:

- Deduct higher education expenses on your income tax return (as, for example, a business expense or a tuition and fees deduction) and also claim a lifetime learning credit based on those same expenses.
- Claim a Hope credit and a lifetime learning credit based on the same qualified higher education expenses.
- Claim a lifetime learning credit based on the same expenses used to figure the taxable portion of a Coverdell ESA or QTP distribution. See *Coordination With Hope and Lifetime Learning Credits* in chapter 5 (Coverdell ESA) and chapter 6 (QTP).
- Claim a credit based on expenses paid with tax-free scholarship, grant, or employer-provided educational

assistance. See *Adjustments to Qualified Expenses*, next.

Adjustments to Qualified Expenses

If you pay qualified higher education expenses with certain **tax-free** funds, you cannot claim a credit for those amounts. You must reduce the qualified expenses by the amount of any tax-free educational assistance you received.

Tax-free educational assistance could include:

- Scholarships,
- Pell grants,
- Employer-provided educational assistance,
- Veterans' educational assistance, and
- Any other nontaxable payments (other than gifts, bequests, or inheritances) received for education expenses.

Do not reduce the qualified expenses by amounts paid with the student's:

- Earnings,
- Loans,
- Gifts,
- Inheritances, and
- Personal savings.

Also, do not reduce the qualified expenses by any scholarship reported as income on the student's return or any scholarship which, by its terms, cannot be applied to qualified tuition and related expenses. For examples, see *Adjustments to Qualified Expenses* in chapter 1.

Refunds. Qualified tuition and related expenses do not include expenses for which you receive a refund. If you paid expenses in 2002, and you receive a refund of those expenses before you file your tax return for 2002, simply reduce the amount of the expenses paid by the amount of the refund received. If you receive the refund after you file your 2002 tax return, see *When Must the Credit Be Repaid (Recaptured)*, later.

Expenses That Do Not Qualify

Qualified tuition and related expenses do not include the cost of:

- Insurance,
- Medical expenses (including student health fees),
- Room and board,
- Transportation, or
- Similar personal, living, or family expenses.

This is true even if the fee must be paid to the institution as a condition of enrollment or attendance.

Qualified tuition and related expenses generally do not include expenses that relate to any course of instruction or other education that involves sports, games or hobbies, or

any noncredit course. However, if the course of instruction or other education is part of the student's degree program or is taken by the student to acquire or improve job skills, these expenses can qualify.

Who Is an Eligible Student?

For purposes of the lifetime learning credit, an eligible student is a student who is enrolled in one or more courses at an **eligible educational institution**.

Who Can Claim a Dependent's Expenses?

If there are qualified higher education costs for your dependent for a year, either you or your dependent, but not both of you, can claim a lifetime learning credit for that dependent's expenses for that year.

For you to be able to claim a lifetime learning credit for your dependent's expenses, you must also claim an exemption for that person. You do this by listing his or her name and other required information on line 6c, Form 1040 (or Form 1040A).

IF you...	THEN only...
claim an exemption on your tax return for a dependent who is an eligible student	you can claim the lifetime learning credit based on that student's expenses. The student cannot claim the credit.
do not claim an exemption on your tax return for a dependent who is an eligible student (even if entitled to the exemption)	the student can claim the lifetime learning credit. You cannot claim the credit based on this student's expenses.

Expenses paid by dependent. If you claim an exemption on your tax return for an eligible student who is your dependent, treat any expenses paid by the student as if you had paid them. Include these expenses when figuring the amount of your lifetime learning credit.



Qualified tuition and related expenses paid directly to an eligible educational institution for your dependent under a court-approved divorce decree are treated as paid by your dependent.

Expenses paid by others. If someone other than you, your spouse, or your dependent (such as a relative or former spouse) makes a payment directly to an eligible educational institution to pay for an eligible student's qualified tuition and related expenses, the student is treated as receiving the payment from the other person. The student is treated as paying the qualified tuition and related expenses to the institution. If you claim an exemption on your tax return for the student, you are considered to have paid the expenses.

Example. Ms. Allen makes a payment directly to an eligible educational institution in 2002 for her grandson Todd's qualified tuition and related expenses. For purposes of claiming a lifetime learning credit, Todd is treated as receiving the money as a gift from his grandmother and, in turn, paying his qualified tuition and related expenses himself.

Unless an exemption for Todd is claimed on someone else's return, only Todd can use the payment to claim a lifetime learning credit.

If anyone, such as Todd's parents, claims an exemption for Todd on his or her tax return, whoever claims the exemption may be able to use the expenses to claim a Hope credit. If anyone else claims an exemption for Todd, Todd cannot claim a Hope credit.

How Is the Credit Figured?

The amount of the lifetime learning credit is 20% of the first \$5,000 of qualified tuition and related expenses you paid for all eligible students. The maximum amount of lifetime learning credit you can claim for 2002 is \$1,000 (20% × \$5,000). However, that amount may be reduced based on your modified adjusted gross income (MAGI). See *Does the Amount of Your Income Affect the Amount of Your Credit*, below.

Example. Bruce and Toni Harper are married and file a joint tax return. For 2002, their MAGI is \$50,000. Toni is attending the community college (an eligible educational institution) to earn credits toward an associate's degree in nursing. She already has a bachelor's degree in history and wants to become a nurse. In August 2002, Toni paid \$4,000 for her Fall 2002 semester. Bruce and Toni can claim an \$800 (20% × \$4,000) lifetime learning credit on their 2002 joint tax return.

Does the Amount of Your Income Affect the Amount of Your Credit?

The amount of your lifetime learning credit is phased out (gradually reduced) if your MAGI is between \$41,000 and \$51,000 (\$82,000 and \$102,000 if you file a joint return). You cannot claim a lifetime learning credit if your MAGI is \$51,000 or more (\$102,000 or more if you file a joint return).

Modified adjusted gross income (MAGI). For most taxpayers, MAGI is adjusted gross income (AGI) as figured on their federal income tax return.

MAGI when using Form 1040A. If you file Form 1040A, your MAGI is the AGI on line 22 of that form.

MAGI when using Form 1040. If you file Form 1040, your MAGI is the AGI on line 36 of that form, modified by adding back any:

- 1) Foreign earned income exclusion,
- 2) Foreign housing exclusion,
- 3) Exclusion of income for bona fide residents of American Samoa, and
- 4) Exclusion of income from Puerto Rico.

You can use *Worksheet 2-1* to figure your MAGI.

Phaseout. The phaseout, if any, can be figured in Part III of Form 8863 or as shown in the following example.

Example. The information is the same as in the Harper example (previous column), except that Bruce and Toni have a MAGI of \$88,000.

They figure the total tentative lifetime learning credit (20% of the first \$5,000 of qualified expenses they paid for all eligible students). As shown in the previous example, the result is an \$800 (20% × \$4,000) total tentative credit.

To figure their allowable credit, they multiply the tentative credit (\$800) by a fraction. Because they are filing a joint return, the numerator of the fraction is \$102,000 (the upper limit) minus their MAGI. The denominator is \$20,000, which is the range of incomes for the phaseout (\$82,000 to \$102,000). The result is the amount of their lifetime learning credit (\$560).

$$\$800 \times \frac{\$102,000 - \$88,000}{\$20,000} = \$560$$

How Is the Credit Claimed?

You claim the lifetime learning credit by completing Parts II and III of **Form 8863** and submitting it with your Form 1040 or 1040A. Enter the credit on Form 1040, line 48, or Form 1040A, line 31. A filled-in Form 8863 is shown in the *Illustrated Example* at the end of this chapter.

An eligible educational institution (such as a college or university) that received payment of qualified tuition and related expenses in 2002 generally must issue **Form 1098-T**, *Tuition Payments Statement*, to each student by January 31, 2003. The information on Form 1098-T will help you determine whether you can claim an education

Worksheet 2-1. MAGI for the Lifetime Learning Credit

1. Enter your adjusted gross income (Form 1040, line 36)	1. _____
2. Enter your foreign earned income exclusion and/or housing exclusion (Form 2555, line 43, or Form 2555-EZ, line 18)	2. _____
3. Enter the amount of income from Puerto Rico that you are excluding . . .	3. _____
4. Enter the amount of income from American Samoa that you are excluding (Form 4563, line 15)	4. _____
5. Add the amounts on lines 2, 3, and 4	5. _____
6. Add the amounts on lines 1 and 5. This is your modified adjusted gross income . Enter this amount on line 10 of your Form 8863	6. _____

tax credit for 2002. The eligible educational institution may ask for a completed **Form W-9S**, *Request for Student's or Borrower's Social Security Number and Certification*, or similar statement to obtain the student's name, address, and taxpayer identification number.

When Must the Credit Be Repaid (Recaptured)?

If, after you file your 2002 tax return, you receive tax-free educational assistance for, or a refund of, an expense you used to figure a lifetime learning credit on that return, you may have to repay all or part of the credit. You must refigure your lifetime learning credit for 2002 as if the assistance or refund was received in 2002. Subtract the amount of the refigured credit from the amount of the credit you claimed. The result is the amount you must repay. You add the repayment (recapture) to your tax liability for the year you receive the assistance or refund (see the instructions for your tax return for that year). Your original 2002 tax return does not change.

Illustrated Example

Judy Green, a single taxpayer, is taking courses at a community college to be recertified to teach in public schools. Her MAGI is \$22,000. Her tax, before credits, is \$1,845. In July 2002 she pays \$700 for the Summer 2002 semester; in August 2002 she pays \$1,900 for the Fall 2002 semester; and in December 2002 she pays another \$1,900 for the Spring semester beginning January 2003. Judy and the college meet all the requirements for the lifetime learning credit. She can use all of the \$4,500 tuition she paid in 2002 when figuring her credit for her 2002 tax return. She figures her credit as shown on the filled-in Form 8863 on the next page.

Note. In *Appendix A* at the end of this publication, there is an example illustrating the use of Form 8863 when both the Hope credit and the lifetime learning credit are claimed on the same tax return.

Education Credits (Hope and Lifetime Learning Credits)

▶ See instructions.
 ▶ Attach to Form 1040 or Form 1040A.

Name(s) shown on return Judy Green Your social security number 000 00 7777

Part I Hope Credit. Caution: The Hope credit may be claimed for no more than 2 tax years for the same student.

1	(a) Student's name (as shown on page 1 of your tax return) First name Last name	(b) Student's social security number (as shown on page 1 of your tax return)	(c) Qualified expenses (but do not enter more than \$2,000 for each student). See instructions	(d) Enter the smaller of the amount in column (c) or \$1,000	(e) Subtract column (d) from column (c)	(f) Enter one-half of the amount in column (e)
2	Add the amounts in columns (d) and (f)			2		
3	Tentative Hope credit. Add the amounts on line 2, columns (d) and (f). If you are claiming the lifetime learning credit, go to Part II; otherwise, go to Part III ▶					3

Part II Lifetime Learning Credit

4	(a) Student's name (as shown on page 1 of your tax return) First name Last name	(b) Student's social security number (as shown on page 1 of your tax return)	(c) Qualified expenses. See instructions
	Judy Green	000 00 7777	4,500
5	Add the amounts on line 4, column (c), and enter the total		5 4,500
6	Enter the smaller of line 5 or \$5,000		6 4,500
7	Tentative lifetime learning credit. Multiply line 6 by 20% (.20) and go to Part III . . . ▶		7 900

Caution: You cannot take the Hope credit and the lifetime learning credit for the same student.

Part III Allowable Education Credits

8	Tentative education credits. Add lines 3 and 7	8	900	
9	Enter: \$102,000 if married filing jointly; \$51,000 if single, head of household, or qualifying widow(er)	9	51,000	
10	Enter the amount from Form 1040, line 36 , or Form 1040A, line 22	10	22,000	
11	Subtract line 10 from line 9. If line 10 is equal to or more than line 9, stop ; you cannot take any education credits	11	29,000	
12	Enter: \$20,000 if married filing jointly; \$10,000 if single, head of household, or qualifying widow(er)	12	10,000	
13	If line 11 is equal to or more than line 12, enter the amount from line 8 on line 14 and go to line 15. If line 11 is less than line 12, divide line 11 by line 12. Enter the result as a decimal (rounded to at least three places)	13	×	
14	Multiply line 8 by line 13 ▶	14	900	
15	Enter the amount from Form 1040, line 44, or Form 1040A, line 28	15	1,845	
16	Enter the total, if any, of your credits from Form 1040, lines 45 through 47, or Form 1040A, lines 29 and 30.	16	0	
17	Subtract line 16 from line 15. If line 16 is equal to or more than line 15, stop ; you cannot take any education credits. ▶	17	1,845	
18	Education credits. Enter the smaller of line 14 or line 17 here and on Form 1040, line 48, or Form 1040A, line 31 ▶	18	900	

*See Pub. 970 for the amount to enter if you are filing Form 2555, 2555-EZ, or 4563 or you are excluding income from Puerto Rico.

3.

Student Loans

Important Changes for 2002

60-month limit eliminated. Beginning in 2002, you are no longer limited to deducting interest paid only during the first 60 months that interest payments are required.

Voluntary interest payments deductible. All student loan interest payments (both required and voluntary) you make on or after January 1, 2002, may be deductible. For further information, see *Voluntary interest payments*, under *Include As Interest*, later.

Income limits on phaseout of deduction increased. The amount of your student loan interest deduction for 2002 will be phased out (gradually reduced) if your modified adjusted gross income (MAGI) is between \$50,000 and \$65,000 (\$100,000 and \$130,000 if you file a joint return). You will not be able to take a deduction if your MAGI is \$65,000 or more (\$130,000 or more if you file a joint return). This is an increase from the 2001 limits of \$40,000 and \$55,000 (\$60,000 and \$75,000 if filing a joint return). See *Does the Amount of Your Income Affect the Amount of Your Deduction*, later.

New modification to adjusted gross income (AGI). Beginning in 2002, for purposes of the phaseout of the deduction, you must add back to your AGI any qualified tuition and fees deducted on Form 1040 or 1040A. Your modified adjusted gross income (MAGI) is your AGI before subtracting any deduction for student loan interest, but with certain other deductions and exclusions added back in. For more information, see *Modified adjusted gross income (MAGI)*, under *Does the Amount of Your Income Affect the Amount of Your Deduction*.

Qualified higher education expenses may be reduced. Beginning in 2002, you must reduce your qualified higher education expenses by the amount of earnings distributed from a qualified tuition program (QTP) and excluded from income. See *What Are Qualified Higher Education Expenses*, later.

Important Change for 2003

Phaseout ranges adjusted for inflation. Beginning in 2003, the income ranges for phasing out the student loan interest deduction may be adjusted annually for inflation.

Introduction

This chapter describes the following two tax benefits related to student loans.

- 1) The student loan interest deduction.
- 2) Canceled (forgiven) student loans.

Student Loan Interest Deduction

If you paid interest on a student loan in 2002, you may be able to deduct up to \$2,500 of the interest you paid.

If you pay \$600 or more in interest during the year to a single lender, you should receive a statement at the end of the year from the lender showing the amount of interest you paid. That information will help you complete your tax return.

What is the tax benefit of the student loan interest deduction? The student loan interest deduction can reduce the amount of your income subject to tax by up to \$2,500 in 2002.

This deduction is taken as an adjustment to income. This means you can claim this deduction even if you do not itemize deductions on Schedule A (Form 1040).

Table 3–1 summarizes the features of the student loan interest deduction.

Table 3–1. **Student Loan Interest Deduction At a Glance**

Do not rely on this table alone. Refer to the text for complete details.

Feature	Description
Maximum benefit	You can decrease your income up to \$2,500.
Loan qualifications	Your student loan <ul style="list-style-type: none">• must have been taken out solely to pay qualified education expenses, and• cannot be from a related person or made under a qualified employer plan.
Student qualifications	The student must be <ul style="list-style-type: none">• you, your spouse, or your dependent, and• enrolled at least half-time in a degree program.
Time limit on deduction	Beginning with payments made in 2002, you can deduct interest paid during the remaining period of your student loan.
Phaseout	The amount of your deduction depends on your income level.

What Is Student Loan Interest?

Generally, student loan interest is interest you paid during the year on a loan you took out to pay qualified higher education expenses (defined later) that were:

- 1) For you, your spouse, or a person who was your dependent (defined later under *Can You Claim the Deduction?*) when you took out the loan,

- 2) Paid within a reasonable period of time (defined later under *Can You Claim the Deduction?*) before or after you took out the loan, and
- 3) For an eligible student (defined later under *Can You Claim the Deduction?*).

Include As Interest

Loan origination fees (other than fees for services), capitalized interest, interest on revolving lines of credit, and interest on refinanced student loans are student loan interest if all other requirements are met. Beginning in 2002, you can deduct all remaining interest paid during the life of the loan, including both required and voluntary interest payments.

Loan origination fees. These are the costs of getting the loan.

Capitalized interest. This is unpaid interest on a student loan that is added by the lender to the outstanding principal balance of the loan.

Interest on revolving lines of credit. Revolving lines of credit, such as credit card debt, qualify if the borrower uses the line of credit (credit card) **only** to pay qualified higher education expenses. See *What Are Qualified Higher Education Expenses*, later in this chapter.

Interest on refinanced student loans. These loans include both:

- Consolidated loans — loans used to refinance more than one student loan of the same borrower, and
- Collapsed loans — two or more loans of the same borrower that are treated by both the lender and the borrower as one loan.

Voluntary interest payments. These are payments made on a qualified student loan during a period when interest payments are not required, such as when the borrower has been granted a deferment.

Example. The payments on Roger's student loan were scheduled to begin in June 2001, 6 months after he graduated from college. He began making payments as required. In September 2002, Roger enrolled in graduate school on a full-time basis. He applied for and was granted deferment of his loan payments while in graduate school. Wanting to pay down his student loan as much as possible, he made loan payments in October and November, 2002. Even though these were voluntary (not required) payments, Roger can deduct the interest paid in October and November.

All remaining interest paid during life of the loan. Beginning in 2002, you can deduct all interest you pay on your student loan, including **voluntary** payments, until the loan is paid off. Prior to that date, you could deduct only the interest paid during the first 60 months you were **required** to make interest payments on the loan.

If you started making required payments before 2002, and your payments continue into 2002 or later, see *Table 3–2* and the example that follows. These illustrate how your student loan interest deduction may change.

Table 3–2. **Changes in Allowable Deduction Period for Student Loan Interest**

Year You Made Interest Payments	Interest Deduction Allowed
Before 1998	No deduction allowed.
1998 – 2001	Interest paid during the first 60 months that interest payments are required on the student loan.
2002 and later	All interest paid on student loan during year, both required and voluntary payments.

Example. You took out a student loan in 1994. Beginning October 1, 1996, you made a payment on the loan every month, as required. In September 2002, you received a small inheritance that allowed you to make an extra payment on your loan during October, November, and December. The following interest payments would qualify for deduction.

- 1996: None
- 1997: None
- 1998: 12 payments (1st year deduction allowed)
- 1999: 12 payments
- 2000: 12 payments
- 2001: 9 payments (end of 60-month period)
- 2002: 15 payments (law changed — 12 required + 3 voluntary payments)

Do Not Include As Interest

You cannot claim a student loan interest deduction for interest on any of the following loans.

- A **loan from a related person**.
- A **loan from a qualified employer plan**.
- A **loan for which you were not legally liable**.

Loan from a related person. You cannot deduct interest on a loan you get from a related person. Related persons include:

- Your spouse,
- Your brothers and sisters,
- Your half brothers and half sisters,
- Your ancestors (parents, grandparents, etc.),
- Your lineal descendants (children, grandchildren, etc.), and
- Certain corporations, partnerships, trusts, and exempt organizations.

Loan from a qualified employer plan. You cannot deduct interest on a loan made under a qualified employer plan or under a contract purchased under such a plan.

Loan for which you are not legally liable. You cannot deduct interest on a loan if, under the terms of the loan, you are not legally obligated to make interest payments.

Example. Susan took out a qualified education loan in 1999 to finance 2 years of college for herself. She was the sole person responsible for the loan. In 2001, after she finished attending school, Susan made the first three payments on the loan. In 2002, Susan's mother helped her with the payments, paying a total of \$750 of interest during the year. Neither Susan nor her mother can deduct the \$750 interest on their 2002 tax returns. Susan cannot deduct it because she did not pay it. Her mother cannot deduct the interest because she is not legally obligated to pay it. This is true whether or not Susan's mother claims her as a dependent.

Can You Claim the Deduction?

Generally, you can claim the deduction if **all** of the following requirements are met.

- 1) Your filing status is any filing status **except** married filing separately.
- 2) No one else is **claiming an exemption** for you on his or her tax return.
- 3) You paid interest on a loan you took out only to pay tuition and other **qualified higher education expenses** for yourself, your spouse, or someone who was your **dependent** when the loan was taken out.
- 4) The education expenses were paid or incurred within a **reasonable period of time** before or after the loan was taken out.
- 5) The person for whom the expenses were paid or incurred was an **eligible student**.

Many of the terms used in the above list are explained later in this chapter.

Is Someone Else Claiming Your Exemption?

Another taxpayer is claiming an exemption for you if he or she lists your name and other required information on line 6c of his or her Form 1040 (or Form 1040A).

What Are Qualified Higher Education Expenses?

Generally, these expenses are the total costs of attending an **eligible educational institution**, including graduate school. They include the costs of:

- 1) Tuition and fees.
- 2) Room and board.
- 3) Books, supplies, and equipment.
- 4) Other necessary expenses (such as transportation).

The expense for room and board qualifies only to the extent that it is not more than the greater of the following two amounts.

- 1) The allowance for room and board, as determined by the eligible educational institution, that was included in the cost of attendance (for federal financial aid purposes) for a particular academic period and living arrangement of the student.
- 2) The actual amount charged if the student is residing in housing owned or operated by the eligible educational institution.

You must reduce your qualified higher education expenses by the **total** amount paid for them with the following tax-free items.

- Employer-provided educational assistance benefits. See chapter 9.
- Tax-free withdrawals from a Coverdell ESA (formerly known as an education IRA). See chapter 5.
- Tax-free withdrawals from a qualified tuition program. See chapter 6.
- U.S. savings bond interest that you exclude from income because it is used to pay qualified higher education expenses. See chapter 8.
- Certain scholarships. See Publication 520.
- Veterans' educational assistance benefits.
- Any other nontaxable payments (other than gifts, bequests, or inheritances) received for education expenses.

Eligible educational institution. An eligible educational institution is any college, university, vocational school, or other postsecondary educational institution eligible to participate in a student aid program administered by the Department of Education. It includes virtually all accredited, public, nonprofit, and proprietary (privately owned profit-making) postsecondary institutions.

For purposes of the student loan interest deduction, the term also includes an institution conducting an internship or residency program leading to a degree or certificate from an institution of higher education, a hospital, or a health care facility that offers postgraduate training.



The educational institution should be able to tell you if it is an eligible educational institution.

No Double Benefit Allowed

You cannot deduct as interest on a student loan any amount you can deduct under any other provision of the tax law (for example, home mortgage interest).

Who Is a Dependent?

Generally, a dependent is someone who:

- Receives most of his or her support from you,
- Is either related to you or lives with you, and

- Is a citizen or resident of the United States, Canada, or Mexico.

More information about dependents can be found in Publication 501, *Exemptions, Standard Deduction, and Filing Information*.

What Is a Reasonable Period of Time?

Qualified higher education expenses are treated as paid or incurred within a reasonable period of time before or after the debt is incurred if they are paid with the proceeds of education loans that are part of a federal postsecondary education loan program.

Even if they are not paid with the proceeds of that type of loan, the expenses are treated as paid or incurred within a reasonable period of time if both of the following requirements are met.

- 1) The expenses relate to a particular **academic period**, and
- 2) The loan proceeds are disbursed within a period that begins 60 days before the start of that academic period and ends 60 days after the end of that academic period.

If neither of the above situations applies, the reasonable period of time usually is determined based on all the relevant facts and circumstances.

Academic period. An academic period includes a semester, trimester, quarter, or other period of study (such as a summer school session) as reasonably determined by an educational institution.

Who Is an Eligible Student?

An eligible student is a student who was enrolled at least half-time in a program leading to a degree, certificate, or other recognized educational credential.

Enrolled at least half-time. A student was enrolled at least half-time if the student was taking at least half the normal full-time work load for his or her course of study.

The standard for what is half of the normal full-time work load is determined by each eligible educational institution. However, the standard may not be lower than those established by the Department of Education under the Higher Education Act of 1965.

How Much Can You Deduct?

Your student loan interest deduction for 2002 is generally the smaller of:

- 1) \$2,500, or
- 2) Your interest payments that were paid in 2002.

However, the amount determined above may be gradually reduced (phased out) or eliminated based on your filing status and modified adjusted gross income (MAGI) as explained next under *Does the Amount of Your Income Affect the Amount of Your Deduction*.

Does the Amount of Your Income Affect the Amount of Your Deduction?

The amount of your student loan interest deduction is phased out (gradually reduced) if your MAGI is between \$50,000 and \$65,000 (\$100,000 and \$130,000 if you file a joint return). You cannot take a student loan interest deduction if your MAGI is \$65,000 or more (\$130,000 or more if you file a joint return).

Table 3–3 describes the effect the amount of your MAGI has on the student loan interest deduction you are allowed to claim.

Table 3–3. **Effect of MAGI on Student Loan Interest Deduction**

IF your filing status is...	AND your MAGI* is...	THEN your student loan interest deduction is...
single,	not more than \$50,000	not affected by the phaseout.
head of household, or	more than \$50,000 but less than \$65,000	reduced because of the phaseout.
qualifying widow(er)	\$65,000 or more	eliminated by the phaseout.
married filing joint return	not more than \$100,000	not affected by the phaseout.
	more than \$100,000 but less than \$130,000	reduced because of the phaseout.
	\$130,000 or more	eliminated by the phaseout.

* Beginning in 2003, amounts will be adjusted for inflation.

How the phaseout works. To figure the phaseout, multiply your interest deduction (before the phaseout) by a fraction. The numerator is your MAGI minus \$50,000 (\$100,000 in the case of a joint return). The denominator is \$15,000 (\$30,000 in the case of a joint return). Subtract the result from your deduction (before the phaseout). This result is the amount you can deduct.

Example 1. During 2002 you paid \$800 interest on a qualified student loan. Your 2002 MAGI is \$125,000 and you are filing a joint return. You must reduce your deduction by \$667, figured as follows.

$$\$800 \times \frac{\$125,000 - \$100,000}{\$30,000} = \$667$$

You can deduct \$133 (\$800 – \$667).

Example 2. The facts are the same as in *Example 1* except that you paid \$2,750 interest. Your maximum deduction for 2002 is \$2,500. You must reduce your maximum deduction by \$2,083, figured as follows.

$$\$2,500 \times \frac{\$125,000 - \$100,000}{\$30,000} = \$2,083$$

You can deduct \$417 (\$2,500 – \$2,083).

Modified adjusted gross income (MAGI). For most taxpayers, MAGI is adjusted gross income (AGI) as figured on their federal income tax return before subtracting any deduction for student loan interest.

MAGI when using Form 1040A. If you file Form 1040A, your MAGI is the AGI on line 22 of that form figured without taking into account any amount on line 18 (Student loan interest deduction) or line 19 (Tuition and fees deduction).

MAGI when using Form 1040. If you file Form 1040, your MAGI is the AGI on line 36 of that form figured without taking into account any amount on line 25 (Student loan interest deduction) or line 26 (Tuition and fees deduction), and modified by adding back any:

- 1) Foreign earned income exclusion,
- 2) Foreign housing exclusion,
- 3) Foreign housing deduction,
- 4) Exclusion of income for bona fide residents of American Samoa, and
- 5) Exclusion of income from Puerto Rico.

How Is the Deduction Figured?

Generally, you figure the deduction using the *Student Loan Interest Deduction Worksheet* in the Form 1040 or Form 1040A instructions. However, if you are filing Form 2555, 2555-EZ, or 4563, or you are excluding income from sources within Puerto Rico, you must complete *Worksheet 3-1* on the next page.

How Is the Deduction Claimed?

The student loan interest deduction is an adjustment to income. To claim the deduction, enter the allowable amount on line 25 of Form 1040, or line 18 of Form 1040A.

Canceled Student Loan

Generally, if you are responsible for making loan payments, and the loan is canceled (forgiven), you must include the amount that was forgiven in your gross income for tax purposes. However, if your student loan is can-

celed, you may not have to include any amount in income. This section describes the requirements for tax-free treatment of canceled student loans.

Which Loans Qualify?

To qualify for tax-free treatment, your loan must contain a provision that all or part of the debt will be canceled if you work:

- For a certain period of time,
- In certain professions, and
- For any of a broad class of employers.

The loan must have been made by a **qualified lender** to assist the borrower in attending an **educational institution**.

Qualified lenders. These include the following.

- 1) The government — federal, state, or local, or an instrumentality, agency, or subdivision thereof.
- 2) A tax-exempt public benefit corporation that has assumed control of a state, county, or municipal hospital and whose employees are considered public employees under state law.
- 3) An educational institution if the loan is made:
 - a) As part of an agreement with an entity described in (1) or (2) under which the funds to make the loan were provided to the educational institution, or
 - b) Under a program of the educational institution that is designed to encourage students to serve in occupations or areas with unmet needs, and where the services required of the students are for or under the direction of a governmental unit or a tax-exempt **section 501(c)(3) organization**.



In satisfying the service requirement in (3)(b), the student must not provide services for the lender organization.

Refinanced loan. If you refinanced a student loan with another loan from an educational institution or a tax-exempt organization, that loan can also be considered as made by a qualified lender.

It is considered made by a qualified lender if it was made under a program of the institution or organization designed to encourage students to serve in occupations or areas with unmet needs, and where the services required of the students are for or are under the direction of a governmental unit or a tax-exempt section 501(c)(3) organization.

Worksheet 3–1. **Student Loan Interest Deduction Worksheet**

(Keep for Your Records)

Use this worksheet instead of the worksheet in the Form 1040 instructions if you are filing **Form 2555, 2555–EZ, or 4563**, or you are excluding income from sources within Puerto Rico. You must complete **Form 1040**, lines 7 through 24 and lines 27 through 33a, plus any amount to be entered on the dotted line next to line 34, before using this worksheet.

1. Enter the total interest you paid in 2002 on qualified student loans. Do not enter more than \$2,500	1.	_____
2. Enter your total income from Form 1040, line 22	2.	_____
3. Enter the total of amounts from Form 1040, lines 23 and 24	3.	_____
4. Enter the total of amounts from Form 1040, lines 27 through 33a, plus any amount you entered on the dotted line next to line 34	4.	_____
5. Add the amounts on lines 3 and 4	5.	_____
6. Subtract the amount on line 5 from the amount on line 2	6.	_____
7. Enter any foreign earned income exclusion and/or housing exclusion (Form 2555, line 43, or Form 2555–EZ, line 18)	7.	_____
8. Enter any housing deduction (Form 2555, line 48)	8.	_____
9. Enter the amount of income from Puerto Rico that you are excluding	9.	_____
10. Enter the amount of income from American Samoa that you are excluding (Form 4563, line 15)	10.	_____
11. Add the amounts on lines 6 through 10. This is your modified adjusted gross income	11.	_____
12. Enter the amount shown below for your filing status	12.	_____
• Single, head of household, or qualifying widow(er) — \$50,000		
• Married filing jointly — \$100,000		
13. Is the amount on line 11 more than the amount on line 12?		
<input type="checkbox"/> No. Skip line 14, enter -0- on line 15, and go to line 16.		
<input type="checkbox"/> Yes. Subtract line 12 from line 11	13.	_____
14. Divide line 13 by \$15,000 (\$30,000 if married filing jointly). Enter the result as a decimal (rounded to at least three places). If the result is 1.000 or more, enter 1.000	14.	_____
15. Multiply line 1 by line 14.	15.	_____
16. Student loan interest deduction. Subtract line 15 from line 1. Enter the result here and on Form 1040, line 25. Do not include this amount in figuring any other deduction on your return (such as on Schedule A, C, E, etc.)	16.	_____

Section 501(c)(3) organization. This is any corporation, community chest, fund, or foundation organized and operated exclusively for one or more of the following purposes.

- Charitable.
- Religious.
- Educational.
- Scientific.
- Literary.

- Testing for public safety.
- Fostering national or international amateur sports competition (but only if none of its activities involve providing athletic facilities or equipment).
- The prevention of cruelty to children or animals.

Educational institution. This is an organization with a regular faculty and curriculum and a regularly enrolled body of students in attendance at the place where the educational activities are carried on.

4.

Tuition and Fees Deduction

Introduction

Beginning in 2002, you may be able to deduct qualified tuition and related expenses paid during the year for yourself, your spouse, or a dependent. You cannot claim this deduction if your filing status is married filing separately or if another person is entitled to claim an exemption for you as a dependent on his or her tax return. The tuition and expenses must be for higher education, as explained later under *Qualified Tuition and Related Expenses*.

What is the tax benefit of the tuition and fees deduction? The tuition and fees deduction can reduce the amount of your income subject to tax by up to \$3,000.

This deduction is taken as an adjustment to income. This means you can claim this deduction even if you do not itemize deductions on Schedule A (Form 1040). This deduction may be beneficial to taxpayers who cannot take either of the education credits because their income is too high.

The tuition and fees deduction will be available for 4 years, 2002 through 2005.

Table 4–1 summarizes the features of the tuition and fees deduction.

Table 4–1. **Tuition and Fees Deduction At a Glance**

Do not rely on this table alone. Refer to the text for complete details.

Question	Answer
What is the maximum benefit?	You can decrease your taxable income by up to \$3,000.
Where is the deduction taken?	As an adjustment to income on Form 1040 or 1040A.
For whom must the expenses be paid?	A student enrolled in an eligible educational institution who is either <ul style="list-style-type: none">• you,• your spouse, or• your dependent.
What tuition and fees are deductible?	Tuition and fees required for enrollment or attendance at an eligible postsecondary educational institution, but not including personal, living, or family expenses, including room and board.

Can You Take the Deduction?

The following rules will help you determine if you can take the tuition and fees deduction.

Who Cannot Take the Deduction?

You cannot take the tuition and fees deduction if any of the following apply.

- Your filing status is married filing separately.
- Another person is entitled to claim an exemption for you as a dependent on his or her tax return. You cannot take the deduction even if the other person does not actually claim that exemption.
- Your modified adjusted gross income (MAGI) is more than \$65,000 (\$130,000 if filing a joint return).
- You were a nonresident alien for any part of the year and did not elect to be treated as a resident alien for tax purposes. More information on nonresident aliens can be found in Publication 519, *U.S. Tax Guide for Aliens*.
- You or anyone else claims a Hope or lifetime learning credit in 2002 with respect to expenses of the student for whom the tuition and related expenses were paid.

Who Can Take the Deduction?

Generally, you can claim the tuition and fees deduction if **all three** of the following requirements are met.

- 1) You pay **qualified tuition and related expenses** of higher education.
- 2) You pay the tuition and related expenses for an **eligible student**.
- 3) The eligible student is either yourself, your spouse, or a **dependent for whom you claim an exemption** on your tax return.

Qualified tuition and related expenses are defined below under *What Expenses Qualify*. Eligible students are defined later under *Who Is an Eligible Student*.

What Expenses Qualify?

The tuition and fees deduction is based on qualified tuition and related expenses you pay for yourself, your spouse, or a dependent for whom you are entitled to claim an exemption on your tax return. Generally, the deduction is allowed for qualified tuition and related expenses paid in 2002 in connection with enrollment at an institution of higher education during 2002 or for an **academic period** beginning in 2002 or in the first 3 months of 2003.

For example, if you paid \$1,500 in December 2002 for qualified tuition for the Spring 2003 semester beginning in January 2003, you may be able to use that \$1,500 in figuring your 2002 deduction.

Academic period. An academic period includes a semester, trimester, quarter, or other period of study (such as a summer school session) as reasonably determined by an educational institution.

Payments with borrowed funds. You can claim a deduction for qualified tuition and related expenses paid with the proceeds of a loan. You use the expenses to figure the deduction for the year in which the expenses are paid, not the year in which the loan is repaid.

Qualified Tuition and Related Expenses

In general, qualified tuition and related expenses are tuition and fees required for enrollment or attendance at an **eligible educational institution**.

Eligible educational institution. An eligible educational institution is any college, university, vocational school, or other postsecondary educational institution eligible to participate in a student aid program administered by the Department of Education. It includes virtually all accredited, public, nonprofit, and proprietary (privately owned profit-making) postsecondary institutions. The educational institution should be able to tell you if it is an eligible educational institution.

Related expenses. Student-activity fees and fees for course-related books, supplies, and equipment are included in qualified tuition and related expenses **only** if the fees must be paid **to the institution** as a condition of enrollment or attendance.

In the following examples, assume that each student is an eligible student and each college or university an eligible educational institution.

Example 1. Jackson is a sophomore in University V's degree program in dentistry. This year, in addition to tuition, he is required to pay a fee to the university for the rental of the dental equipment he will use in this program. Because the equipment rental fee must be paid to University V for enrollment and attendance, Jackson's equipment rental fee is a **qualified related expense**.

Example 2. Donna and Charles, both first-year students at College W, are required to have certain books and other reading materials to use in their mandatory first-year classes. The college has no policy about how students should obtain these materials, but any student who purchases them from College W's bookstore will receive a bill directly from the college. Charles bought his books from a friend, so what he paid for them is **not** a qualified expense. Donna bought hers at College W's bookstore. Although Donna paid College W directly for her first-year books and materials, her payment is **not** a qualified related expense because the books and materials are **not required** to be purchased from College W for enrollment or attendance at the institution.

Example 3. When Marci enrolled at College X for her freshman year, she had to pay a separate student activity fee in addition to her tuition. This activity fee is required of all students, and is used solely to fund on-campus organizations and activities run by students, such as the student newspaper and the student government. No portion of the fee covers personal expenses. Although labeled as a student activity fee, the fee is required for Marci's enrollment and attendance at College X. Therefore, it is a **qualified related expense**.

No Double Benefit Allowed

You cannot:

- Deduct higher education tuition and fees if you deduct these expenses under any other provision of the law, for example, as a business expense,
- Deduct qualified higher education tuition and fees for a student on your income tax return if you or anyone else claims a Hope or lifetime learning credit for that same student in the same year,
- Deduct qualified tuition and related expenses that have been paid with tax-free distributions of earnings from a qualified tuition plan (QTP) or a Coverdell education savings account (ESA), or paid with tax-free interest on U.S. savings bonds (Form 8815), or
- Deduct qualified tuition and related expenses that have been paid with tax-free scholarship, grant, or employer-provided educational assistance. See the following section on *Adjustments to Qualified Expenses*.

Adjustments to Qualified Expenses

If you pay qualified higher education expenses with certain **tax-free** funds, you cannot claim a deduction for those amounts. You must reduce the qualified expenses by the amount of any tax-free educational assistance you received.

Tax-free educational assistance could include:

- Scholarships,
- Pell grants,
- Employer-provided educational assistance,
- Veterans' educational assistance, and
- Any other nontaxable payments (other than gifts, bequests, or inheritances) received for education expenses.

Do not reduce the qualified expenses by amounts paid with the student's:

- Earnings,
- Loans,
- Gifts,
- Inheritances, and
- Personal savings.

Also, do not reduce the qualified expenses by any scholarship reported as income on the student's return or any scholarship which, by its terms, cannot be applied to qualified tuition and related expenses.

Example 1. In 2002, Jackie paid \$3,000 for tuition and \$5,000 for room and board at University X. The university did not require her to pay any fees in addition to her tuition in order to enroll in or attend classes. To help pay these costs, she was awarded a \$2,000 scholarship and a \$4,000 student loan.

The scholarship is a qualified scholarship that is excludable from Jackie's income, and, for purposes of calculating the tuition and fees deduction, it must first reduce her tuition (her only "qualified expense"). The student loan is not considered "tax-free educational assistance," so it does not reduce the qualified expenses. Therefore, Jackie is treated as having paid only \$1,000 in qualified expenses (\$3,000 tuition – \$2,000 scholarship) to University X in 2002.

Example 2. The facts are the same as in *Example 1*, except that Jackie reports her entire scholarship as income on her tax return. In this case, the scholarship is not treated as a qualified scholarship, so is allocated to expenses other than qualified expenses. Therefore, Jackie is treated as paying the entire \$3,000 tuition to University X with other funds, the amount on which her tuition and fees deduction would be calculated.

Refunds. Qualified tuition and related expenses do not include expenses for which you receive a refund. If you paid expenses in 2002, and you receive a refund of those expenses before you file your tax return for 2002, simply reduce the amount of the expenses paid by the amount of the refund received. If you receive the refund after you file your 2002 tax return, see *Non-Itemized Deduction Recoveries*, under *Recoveries*, in Publication 525.

Expenses That Do Not Qualify

Qualified tuition and related expenses do not include the cost of:

- Insurance,
- Medical expenses (including student health fees),
- Room and board,
- Transportation, or
- Similar personal, living, or family expenses.

This is true even if the fee must be paid to the institution as a condition of enrollment or attendance.

Qualified tuition and related expenses generally do not include expenses that relate to any course of instruction or other education that involves sports, games or hobbies, or any noncredit course. However, if the course of instruction or other education is part of the student's degree program, these expenses can qualify.

Who Is an Eligible Student?

For purposes of the tuition and fees deduction, an eligible student is a student who is enrolled in one or more courses at an **eligible educational institution**.

Who Can Claim a Dependent's Expenses?

Generally, in order to claim the tuition and fees deduction for qualified higher education expenses for a dependent, an individual must:

- 1) Have paid the expenses, and
- 2) Claim an exemption for the student as a dependent.

For you to be able to deduct qualified expenses for your dependent, you must claim an exemption for that individual.

IF you...	AND...	THEN...
claim an exemption on your tax return for a dependent who is an eligible student	you paid all qualified tuition and fees for that student	only you can deduct the qualified tuition and fees that you paid. The student cannot take a deduction.
claim an exemption for the student	the student paid all qualified expenses	no one is allowed to take a deduction.
do not claim an exemption, but are eligible to	you paid all qualified expenses	no one is allowed to take a deduction.
do not claim an exemption, but are eligible to	the student paid all qualified expenses	no one is allowed to take a deduction.
are not eligible to claim an exemption	you paid all qualified expenses	only the student can deduct the amount you paid. The amount you paid is treated as a gift to the student.
are not eligible to claim an exemption	the student paid all qualified expenses	only the student can take a deduction.

Expenses paid under divorce decree. Qualified tuition and related expenses paid directly to an eligible educational institution for a student under a court-approved divorce decree are treated as paid by the student. Only the student would be eligible to take a tuition and fees deduction for that payment, and then only if no one else could claim an exemption for the student.

Expenses paid by others. If someone other than you, your spouse, or your dependent (such as a relative or former spouse) makes a payment directly to an eligible

educational institution to pay for an eligible student's qualified tuition and related expenses, the student is treated as receiving the payment from the other person. The student is then treated as paying the qualified tuition and related expenses to the institution and would be the only one eligible to take a deduction, provided no one else could claim an exemption for the student.

Example. Ms. Baker makes a payment directly to an eligible educational institution in 2002 for her grandson Dan's qualified tuition and related expenses. For purposes of deducting tuition and fees, Dan is treated as receiving the money as a gift from his grandmother and, in turn, paying his own qualified tuition and related expenses.

If an exemption cannot be claimed for Dan on anyone else's tax return, only Dan can claim a tuition and fees deduction for his grandmother's payment. If someone else is eligible to claim an exemption for Dan, no one will be allowed a deduction for Ms. Baker's payment.

How Is the Deduction Figured?

The maximum deduction you can claim in 2002 is \$3,000. However, the amount of your modified adjusted gross income (MAGI) determines whether the deduction is allowed. See *Does the Amount of Your Income Affect the Amount of Your Deduction*, next.

Does the Amount of Your Income Affect the Amount of Your Deduction?

If your MAGI is more than \$65,000 (\$130,000 if you file a joint return), you cannot claim a deduction for qualified tuition and related expenses.

Modified adjusted gross income (MAGI). For most taxpayers, MAGI is adjusted gross income (AGI) as figured on their federal income tax return.

MAGI when using Form 1040A. If you file Form 1040A, your MAGI is the AGI on line 22 of that form, figured without taking into account any amount on line 19 (Tuition and fees deduction).

MAGI when using Form 1040. If you file Form 1040, your MAGI is the AGI on line 36 of that form, figured without taking into account any amount on line 26 (Tuition and fees deduction) and modified by adding back any:

- 1) Foreign earned income exclusion,
- 2) Foreign housing exclusion,
- 3) Foreign housing deduction,
- 4) Exclusion of income for bona fide residents of American Samoa, and
- 5) Exclusion of income from Puerto Rico.

You can use *Worksheet 4-1* to figure your MAGI.

Worksheet 4-1. MAGI for the Tuition and Fees Deduction

(Keep for your records)

Use this worksheet instead of the worksheet in the Form 1040 instructions if you are filing Form 2555, 2555-EZ, or 4563, or you are excluding income from sources within Puerto Rico. Before using this worksheet, you must complete Form 1040, lines 7 through 25 and lines 27 through 33a and figure any amount to be entered on the dotted line next to line 34.

1. Enter the amount from Form 1040, line 22	1.	_____
2. Enter the total from Form 1040, lines 23 through 25	2.	_____
3. Enter the total from Form 1040, lines 27 through 33a, plus any amount entered on the dotted line next to line 34	3.	_____
4. Add the amounts on lines 2 and 3	4.	_____
5. Subtract the amount on line 4 from the amount on line 1	5.	_____
6. Enter your foreign earned income exclusion and/or housing exclusion (Form 2555, line 43, or Form 2555-EZ, line 18)	6.	_____
7. Enter your foreign housing deduction (Form 2555, line 48)	7.	_____
8. Enter the amount of income from Puerto Rico you are excluding . . .	8.	_____
9. Enter the amount of income from American Samoa you are excluding (Form 4563, line 15)	9.	_____
10. Add the amounts on lines 5 through 9. This is your modified adjusted gross income . . .	10.	_____

Note. If the amount on line 10 is more than \$65,000 (\$130,000 if married filing jointly), you cannot take the deduction for tuition and fees.

How Is the Deduction Claimed?

You deduct qualified tuition and fees by entering the amount you have figured on Form 1040, line 26, or Form 1040A, line 19.

An eligible educational institution (such as a college or university) that received payment of qualified tuition and related expenses in 2002 generally must issue **Form**

1098-T, *Tuition Payments Statement*, to each student by January 31, 2003. The information on Form 1098-T will help you determine whether you can claim a deduction for 2002. The eligible educational institution may ask for a completed **Form W-9S**, *Request for Student's or Borrower's Social Security Number and Certification*, or similar statement to obtain the student's name, address, and taxpayer identification number.

5.

Coverdell Education Savings Account (ESA) — Formerly Education IRA

Important Changes for 2002

Maximum contribution increased. Beginning in 2002, the most you can contribute each year per beneficiary to a Coverdell ESA is increased from \$500 to \$2,000. See *Contribution Limits*, under *Contributions*, for more information.

Income limits increased for married couples filing a joint return. If you are married and filing a joint return for 2002, your contribution limit is not reduced if your modified adjusted gross income (MAGI) is \$190,000 or less. Your contribution limit is gradually reduced (phased out) if your MAGI is more than \$190,000 but less than \$220,000. If your MAGI is \$220,000 or more, you cannot contribute to a Coverdell ESA. This is an increase from the 2001 limits of \$150,000 and \$160,000. See *Contribution Limits*, under *Contributions*, for more information.

Contribution due date extended. The final date on which you can make contributions to a Coverdell ESA for any year has been extended from the last day of the year to the due date of your return for that year (not including extensions). If you are a calendar year taxpayer, you generally have until April 15, 2003, to make your contribution for the 2002 tax year.

Qualified education expenses expanded. Beginning in 2002, qualified education expenses include certain elementary and secondary education expenses, as well as certain expenses for special needs students. For more information, see *Qualified Education Expenses*, under *What Is a Coverdell ESA*.

Limit on room and board changed. The limit on the amount that is considered reasonable for room and board expenses has changed. You must contact the educational institution for its qualified room and board costs. For more information, see *Qualified higher education expenses*, under *Higher Education*.

Age limitations waived for special needs beneficiaries. Beginning in 2002, you can make contributions to a Coverdell ESA for a special needs beneficiary after his or her 18th birthday. Also, you can leave assets in a Coverdell ESA set up for a special needs beneficiary after he or she reaches age 30. For more information, see *What Is a Coverdell ESA*.

Coverdell ESA coordinated with Hope and lifetime learning credits. Beginning in 2002, you may be able to claim a Hope or lifetime learning credit in the same year in which the beneficiary takes a tax-free withdrawal from a

Coverdell ESA. However, you cannot use the expenses on which the credit is based to figure the taxable portion of the withdrawal from the Coverdell ESA. See *Coordination With Hope and Lifetime Learning Credits*, under *Taxable Withdrawals*, for more information.

Any part of the withdrawal from the Coverdell ESA that is taxable only because an education credit was claimed is not subject to the 10% additional tax on taxable withdrawals.

Coverdell ESA coordinated with qualified tuition program (QTP). Beginning in 2002, if a designated beneficiary takes withdrawals from both a Coverdell ESA and a QTP in the same year, and the total withdrawn is greater than the beneficiary's adjusted qualified higher education expenses, those expenses must be allocated between the withdrawal from the Coverdell ESA and the withdrawal from the QTP before figuring how much of each withdrawal is taxable. For more information, see *Coordination With Qualified Tuition Program (QTP) Withdrawals*, under *Taxable Withdrawals*.

Definition of family members expanded. Beginning in 2002, for purposes of rollovers and changes of designated beneficiaries, the definition of family members is expanded to include first cousins of the designated beneficiary. For more information, see *Rollovers and Other Transfers*.

Contributions to both Coverdell ESA and QTP allowed in same year. Beginning in 2002, you can make contributions, without penalty, to a Coverdell ESA even if contributions are also being made to a QTP on behalf of the same designated beneficiary. Before 2002, contributions to the Coverdell ESA that were made in the same year as contributions to a QTP were subject to the additional tax on excess contributions.

Important Change for 2003

Deadline for withdrawing excess contributions changed. There will be no additional tax on excess contributions if the excess (and earnings on that amount) is withdrawn before the beginning of the sixth month following the year of the contribution. Generally, a calendar year taxpayer will have until May 31, 2003, to withdraw an excess contribution for 2002. Previously, excess contributions (and earnings) had to be withdrawn by the due date (including extensions) for filing the beneficiary's tax return or, if no return was required, by April 15 of the following year. See *Additional Tax on Taxable Withdrawals* for more information.

Introduction

You may be able to establish a Coverdell ESA to finance the qualified education expenses of a designated beneficiary. Until July 26, 2001, this type of account was called an education individual retirement arrangement (or Education IRA).

Contributions to a Coverdell ESA are not deductible, but amounts deposited in the account grow tax free until withdrawn. Generally, you can contribute up to \$2,000 cash for

a year per beneficiary. In the case of a special needs beneficiary, the beneficiary can be 18 or older.

There is no limit on the number of separate Coverdell ESAs that can be established for a designated beneficiary. However, total contributions for the beneficiary in any year cannot be more than \$2,000, no matter how many accounts have been established. See *Contributions*, later.

If, for a year, withdrawals from an account are not more than a designated beneficiary's qualified education expenses at an eligible educational institution, the beneficiary will not owe tax on the withdrawals. See *Tax-Free Withdrawals*, later.

Table 5–1 summarizes the main features of the Coverdell ESA.

Table 5–1. **Coverdell ESA At a Glance**

Do not rely on this table alone. It provides only general highlights. See the text for definitions of terms in bold type and for more complete explanations.

Question	Answer
What is a Coverdell ESA ?	A savings account that is set up to pay the qualified education expenses of a designated beneficiary .
Where can it be established?	It can be opened in the United States at any bank or other IRS-approved entity that offers Coverdell ESAs.
Who can a Coverdell ESA be set up for?	Any beneficiary who is under age 18 or a special needs beneficiary.
Who can contribute to a Coverdell ESA?	Generally, any individual (including the beneficiary) whose modified adjusted gross income for the year is less than \$110,000 (\$220,000 in the case of a joint return).

What Is a Coverdell ESA?

A Coverdell ESA is a trust or custodial account created or organized in the United States only for the purpose of paying the **qualified education expenses** of the **designated beneficiary** of the account.

When the account is established, the designated beneficiary must be under age 18 or a special needs beneficiary.

To be treated as a Coverdell ESA, the account must be designated as a Coverdell ESA when it is created.

The document creating and governing the account must be in writing and must satisfy the following requirements.

- 1) The trustee or custodian must be a bank or an entity approved by the IRS.
- 2) The document must provide that the trustee or custodian can only accept a contribution that meets all of the following conditions.
 - a) Is in cash.

- b) Is made before the beneficiary reaches age 18, unless the beneficiary is a special needs beneficiary.
 - c) Would not result in total contributions for the year (not including rollover contributions) being more than \$2,000.
- 3) Money in the account cannot be invested in life insurance contracts.
 - 4) Money in the account cannot be combined with other property except in a common trust fund or common investment fund.
 - 5) The balance in the account generally must be withdrawn within 30 days after the earlier of the following events.
 - a) The beneficiary reaches age 30, unless the beneficiary is a special needs beneficiary.
 - b) The beneficiary's death.

Qualified Education Expenses

Generally, these are expenses required for the enrollment or attendance of the **designated beneficiary** at an eligible school. Beginning in 2002, in addition to certain higher education expenses, certain expenses for education at elementary and secondary schools can also be qualified education expenses.

Designated beneficiary. The individual named in the document creating the trust or custodial account to receive the benefit of the funds in the account is the designated beneficiary.

Elementary and Secondary Education

Eligible elementary and secondary schools and qualified expenses are defined below.

Eligible school. This is any public, private, or religious school that provides elementary or secondary education (kindergarten through grade 12), as determined under state law.

Qualified elementary and secondary education expenses. To be qualified, elementary and secondary education expenses must be related to enrollment or attendance at an eligible school, as shown below.

- 1) The following expenses must be incurred by a designated beneficiary in connection with enrollment or attendance at an eligible school.
 - a) Tuition and fees.
 - b) Books, supplies, and equipment.
 - c) Academic tutoring.
 - d) Special needs services for a special needs beneficiary. (See *Caution* on the next page.)
- 2) The expenses listed below must be required or provided by an eligible school in connection with attendance or enrollment.

- a) Room and board.
 - b) Uniforms.
 - c) Transportation.
 - d) Supplementary items and services (including extended day programs).
- 3) The purchase of computer technology, equipment, or Internet access and related services is a qualified elementary and secondary education expense if it is to be used by the beneficiary and the beneficiary's family during any of the years the beneficiary is in school. (This does not include expenses for computer software designed for sports, games, or hobbies unless the software is predominantly educational in nature.)

Higher Education

Eligible postsecondary schools and qualified expenses are shown below.

Eligible educational institution. This is any college, university, vocational school, or other postsecondary educational institution eligible to participate in a student aid program administered by the Department of Education. It includes virtually all accredited, public, nonprofit, and proprietary (privately owned profit-making) postsecondary institutions. The educational institution should be able to tell you if it is an eligible educational institution.

Qualified higher education expenses. To be qualified, each higher education expense must meet certain criteria, as shown below.

- 1) The following expenses must be required for enrollment or attendance of a designated beneficiary at an eligible educational institution.
 - a) Tuition and fees.
 - b) Books, supplies, and equipment.
- 2) Expenses for special needs services needed by a special needs beneficiary must be incurred in connection with enrollment or attendance at an eligible educational institution. (See *Caution* in the next column.)
- 3) Expenses for room and board must be incurred by students who are enrolled at least half-time (defined later).

The expense for room and board qualifies only to the extent that it does not exceed the greater of the following two amounts.

 - a) The allowance for room and board, as determined by the eligible educational institution, that was included in the cost of attendance (for federal financial aid purposes) for a particular academic period and living arrangement of the student.

- b) The actual amount charged if the student is residing in housing owned or operated by the eligible educational institution.

- 4) Any contribution to a qualified tuition program (QTP) must be on behalf of the designated beneficiary of the Coverdell ESA. (See chapter 6, *Qualified Tuition Program (QTP)*.)

Half-time student. A student is enrolled "at least half-time" if he or she is enrolled for at least half the full-time academic work load for the course of study the student is pursuing, as determined under the standards of the school where the student is enrolled.



As of this printing, regulations defining a **special needs beneficiary** have not been released. If available, the definition will be included in *Publication 553, Highlights of 2002 Tax Changes*, which will be issued in early 2003.

Contributions

Any individual (including the designated beneficiary for whose benefit the account is established) can contribute to a Coverdell ESA if the individual's **modified adjusted gross income (MAGI)** for the year is less than \$110,000. For individuals filing joint returns, that amount is \$220,000.

Organizations, such as corporations and trusts, can also contribute to Coverdell ESAs. There is no requirement that an organization's income be below a certain level.

Contributions must meet all of the following requirements.

- 1) They must be in cash.
- 2) They cannot be made after the beneficiary reaches age 18, unless the beneficiary is a special needs beneficiary, and
- 3) They must be made by the due date of the contributor's tax return (not including extensions).

Contributions can be made to one or several Coverdell ESAs for the same designated beneficiary provided that the total contributions are not more than the contribution limits (defined later) for a year.

Beginning in 2002, contributions can be made, without penalty, to both a Coverdell ESA and a QTP in the same year for the same beneficiary.

Table 5-2 (see next page) summarizes many of the features of contributing to a Coverdell ESA.

Modified adjusted gross income (MAGI). For most taxpayers, MAGI is adjusted gross income (AGI) as figured on their federal income tax return.

MAGI when using Form 1040A. If you file Form 1040A, your MAGI is the AGI on line 22 of that form.

Table 5–2. Coverdell ESA Contributions At a Glance

Do not rely on this table alone. It provides only general highlights. See the text for more complete explanations.

Question	Answer
Are contributions deductible?	No.
Why should someone contribute to a Coverdell ESA?	Earnings on the account grow tax free until withdrawn.
What is the annual contribution limit per designated beneficiary?	\$2,000 for each designated beneficiary.
What if more than one Coverdell ESA has been opened for the same designated beneficiary?	The annual contribution limit is \$2,000 for each beneficiary, no matter how many Coverdell ESAs are set up for that beneficiary.
What if more than one individual makes contributions for the same designated beneficiary?	The annual contribution limit is \$2,000 per beneficiary, no matter how many individuals contribute.
Can contributions other than cash be made to a Coverdell ESA?	No.
When must contributions stop?	No contributions can be made to a beneficiary's Coverdell ESA after he or she reaches age 18, unless the beneficiary is a special needs beneficiary.

MAGI when using Form 1040. If you file Form 1040, your MAGI is the AGI on line 36 of that form, modified by adding back any:

- 1) Foreign earned income exclusion,
- 2) Foreign housing exclusion,
- 3) Exclusion of income for bona fide residents of American Samoa, and
- 4) Exclusion of income from Puerto Rico.

You can use *Worksheet 5–1* to figure your MAGI.

Contribution Limits

There are two yearly limits:

- 1) One on the total amount that can be contributed for each designated beneficiary in any year, and
- 2) One on the amount that any individual can contribute for any one designated beneficiary for a year.

Limit for each designated beneficiary. For 2002, the total of all contributions to all Coverdell ESAs set up for the benefit of any one designated beneficiary cannot be more than \$2,000. This includes contributions (other than rol-

lovers) to all the beneficiary's Coverdell ESAs from all sources. Rollovers are discussed under *Rollovers and Other Transfers*, later.

Example. When Maria Luna was born in 2001, three separate Coverdell ESAs were set up for her, one by her parents, one by her grandfather, and one by her aunt. In 2002, the total of all contributions to Maria's three Coverdell ESAs cannot be more than \$2,000. For example, if her grandfather contributed \$2,000 to one of her Coverdell ESAs, no one else could contribute to any of her three accounts. Or, if her parents contributed \$1,000 and her aunt \$600, her grandfather or someone else could contribute no more than \$400. These contributions could be put into any of Maria's Coverdell ESA accounts.

Limit for each contributor. Generally, you can contribute up to \$2,000 for each designated beneficiary for 2002. This is the most you can contribute for the benefit of any one beneficiary for the year, regardless of the number of Coverdell ESAs set up for the beneficiary.

Example. The facts are the same as in the previous example except that Maria Luna's older brother, Edgar, also has a Coverdell ESA. If their grandfather contributed \$2,000 to Maria's Coverdell ESA in 2002, he could also contribute \$2,000 to Edgar's Coverdell ESA.

Reduced limit. Your contribution limit may be reduced. If your **MAGI** (defined earlier) is between \$95,000 and \$110,000 (between \$190,000 and \$220,000 if filing a joint return), the \$2,000 limit for each designated beneficiary is gradually reduced (see *Figuring the limit*, next). If your MAGI is \$110,000 or more (\$220,000 or more if filing a joint return), you cannot contribute to anyone's Coverdell ESA.

Figuring the limit. To figure the limit on the amount you can contribute for each designated beneficiary, multiply \$2,000 by a fraction. The numerator (top number) is your MAGI minus \$95,000 (\$190,000 if filing a joint return). The

Worksheet 5–1. MAGI for a Coverdell ESA

1. Enter your adjusted gross income (Form 1040, line 36)	1. _____
2. Enter your foreign earned income exclusion and/or housing exclusion (Form 2555, line 43, or Form 2555–EZ, line 18)	2. _____
3. Enter the amount of income from Puerto Rico that you are excluding . . .	3. _____
4. Enter the amount of income from American Samoa that you are excluding (Form 4563, line 15)	4. _____
5. Add the amounts on lines 2, 3, and 4	5. _____
6. Add the amounts on lines 1 and 5. This is your modified adjusted gross income	6. _____

denominator (bottom number) is \$15,000 (\$30,000 if filing a joint return). Subtract the result from \$2,000. This is the amount you can contribute for each beneficiary. You can use *Worksheet 5-2* to figure the limit on your contributions.

Worksheet 5-2. Coverdell ESA Contribution Limit

1. Maximum contribution	1. <u>\$ 2,000</u>
2. Enter your modified adjusted gross income (MAGI) for purposes of figuring the contribution limit to a Coverdell ESA (see definition or <i>Worksheet 5-1</i> earlier)	2. _____
3. Enter \$190,000 if married filing jointly; \$95,000 for all other filers	3. _____
4. Subtract line 3 from line 2. If zero or less, enter -0- on line 4, skip lines 5 through 7, and enter \$2,000 on line 8	4. _____
5. Enter \$30,000 if married filing jointly; \$15,000 for all other filers	5. _____
Note. <i>If the amount on line 4 is greater than or equal to the amount on line 5, stop here. You are not allowed to contribute to a Coverdell ESA for 2002.</i>	
6. Divide line 4 by line 5 and enter the result as a decimal (rounded to at least 3 places)	6. _____
7. Multiply line 1 by line 6	7. _____
8. Subtract line 7 from line 1	8. _____
Note: <i>The total Coverdell ESA contributions from all sources for the designated beneficiary during the tax year may not exceed \$2,000.</i>	

Example. Paul, who is single, had MAGI of \$96,500 for 2002. Paul can contribute up to \$1,800 in 2002 for each beneficiary, as shown in the illustrated *Worksheet 5-2*.

Additional Tax on Excess Contributions

The beneficiary must pay a 6% excise tax each year on excess contributions that are in a Coverdell ESA at the end of the year. Excess contributions are the **total** of the following two amounts.

- 1) Contributions to any designated beneficiary's Coverdell ESA for the year that are more than \$2,000 (or, if less, the total of each contributor's limit for the year, as discussed earlier).
- 2) Excess contributions for the preceding year, reduced by the total of the following two amounts:
 - a) Withdrawals (other than those rolled over as discussed later) made during the year, and
 - b) The contribution limit for the current year minus the amount contributed for the current year.

Exceptions. The excise tax does not apply if excess contributions made during 2002 (and any earnings on them) are withdrawn before the first day of the sixth month of the following tax year (June 1, 2003, for a calendar year taxpayer).

The withdrawn earnings must be included in gross income for the year in which the excess contribution was made.

The excise tax does not apply to any rollover contribution.

How to figure. You figure this excise tax in Part V, Form 5329, *Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts*. You report it on line 58, Form 1040.

Worksheet 5-2. Coverdell ESA Contribution Limit — Illustrated

1. Maximum contribution	1. <u>\$ 2,000</u>
2. Enter your modified adjusted gross income (MAGI) for purposes of figuring the contribution limit to a Coverdell ESA (see definition or <i>Worksheet 5-1</i> earlier)	2. <u>96,500</u>
3. Enter \$190,000 if married filing jointly; \$95,000 for all other filers	3. <u>95,000</u>
4. Subtract line 3 from line 2. If zero or less, enter -0- on line 4, skip lines 5 through 7, and enter \$2,000 on line 8	4. <u>1,500</u>
5. Enter \$30,000 if married filing jointly; \$15,000 for all other filers	5. <u>15,000</u>
Note. <i>If the amount on line 4 is greater than or equal to the amount on line 5, stop here. You are not allowed to contribute to a Coverdell ESA for 2002.</i>	
6. Divide line 4 by line 5 and enter the result as a decimal (rounded to at least 3 places)	6. <u>.100</u>
7. Multiply line 1 by line 6	7. <u>200</u>
8. Subtract line 7 from line 1	8. <u>1,800</u>
Note: <i>The total Coverdell ESA contributions from all sources for the designated beneficiary during the tax year may not exceed \$2,000.</i>	

Rollovers and Other Transfers

Assets can be rolled over from one Coverdell ESA to another. The designated beneficiary can be changed and the beneficiary's interest can be transferred to a spouse or former spouse because of divorce.

Rollovers

Any amount withdrawn from a Coverdell ESA and rolled over to another Coverdell ESA for the benefit of the same beneficiary or a member of the beneficiary's family who is under age 30 is not taxable. An amount is rolled over if it is

paid to another Coverdell ESA within 60 days after the date of the withdrawal.

Members of the beneficiary’s family. The amounts in a Coverdell ESA can be transferred tax free to the designated beneficiary’s spouse or any of the following other members of the beneficiary’s family.

- 1) Son or daughter or descendant of son or daughter.
- 2) Stepson or stepdaughter.
- 3) Brother, sister, stepbrother, or stepsister.
- 4) Father or mother or ancestor of either.
- 5) Stepfather or stepmother.
- 6) Son or daughter of a brother or sister.
- 7) Brother or sister of father or mother.
- 8) Son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law.
- 9) The spouse of any individual listed above.
- 10) First cousin.



Only one rollover per Coverdell ESA is allowed during the 12-month period ending on the date of the payment or withdrawal.

Changing the Designated Beneficiary

The designated beneficiary can be changed to a member of the beneficiary’s family (defined earlier). There are no tax consequences if, at the time of the change, the new beneficiary is under age 30.

Transfer Because of Divorce

If a spouse or former spouse receives a Coverdell ESA under a divorce or separation instrument, it is not a taxable transfer. After the transfer, the spouse or former spouse treats the Coverdell ESA as his or her own.

Withdrawals

The designated beneficiary of a Coverdell ESA can take withdrawals at any time. Whether the withdrawals are tax free depends, in part, on whether the withdrawals are more than the amount of **adjusted qualified education expenses** (defined next) that the beneficiary has in the tax year.

See *Table 5–3* for highlights.

Table 5–3. Coverdell ESA Withdrawals At a Glance

Do not rely on this table alone. It provides only general highlights. See the text for definitions of terms in bold type and for more complete explanations.

Question	Answer
Is a withdrawal from a Coverdell ESA to pay for a designated beneficiary’s qualified education expenses tax free?	Generally, yes, to the extent the amount of the withdrawal is not more than the designated beneficiary’s adjusted qualified education expenses.
After the designated beneficiary completes his or her education at an eligible educational institution , may amounts remaining in the Coverdell ESA be withdrawn?	Yes. Amounts must be withdrawn when the designated beneficiary reaches age 30, unless he or she is a special needs beneficiary. Also, certain transfers to members of the beneficiary’s family are permitted.
Does the designated beneficiary need to be enrolled for a minimum number of courses to take a tax-free withdrawal?	No.

Adjusted qualified education expenses. To determine if total withdrawals for the year are more or less than the amount of qualified expenses, reduce total qualified education expenses by any tax-free educational assistance. Tax-free educational assistance could include:

- Scholarships that are excluded from gross income,
- Veterans’ educational assistance,
- Pell grants,
- Employer-provided educational assistance, and
- Any other nontaxable payments (other than gifts, bequests, or inheritances) received for education expenses.

The amount you get by subtracting tax-free educational assistance from your total qualified education expenses is your adjusted qualified education expenses.

Tax-Free Withdrawals

Generally, withdrawals are tax free if they are not more than the beneficiary’s adjusted qualified education expenses for the year.

Taxable Withdrawals

Generally, a portion of the withdrawals is taxable to the beneficiary if the withdrawals are more than the beneficiary's adjusted qualified education expenses for the year.

Figuring the Taxable Portion of a Withdrawal

The taxable portion is the amount of the excess withdrawal that represents earnings that have accumulated tax free in the account. Figure the taxable portion as shown in the following steps.

- 1) Multiply the amount withdrawn by a fraction. The numerator is the total contributions in the account and the denominator is the total balance in the account before the withdrawal(s).
- 2) Subtract the amount figured in (1) from the total amount withdrawn during the year. This is the amount of earnings included in the withdrawal(s).
- 3) Multiply the amount of earnings figured in (2) by a fraction. The numerator is the adjusted qualified education expenses paid during the year and the denominator is the total amount withdrawn during the year.
- 4) Subtract the amount figured in (3) from the amount figured in (2). This is the amount the beneficiary must include in income.

The taxable amount must be reported on line 21, Form 1040.

Example. You receive an \$850 distribution from a Coverdell ESA to which \$1,500 has been contributed. The balance in the account before the withdrawal was \$1,800. You had \$700 of adjusted qualified education expenses for the year. Using the steps above, you figure the taxable portion of your withdrawal as follows.

- 1) $\$850 \times (\$1,500 \div \$1,800) = \708 (basis portion of distribution)
- 2) $\$850 - \$708 = \$142$ (earnings included in distribution)
- 3) $\$142 \times (\$700 \div \$850) = \117 (tax-free earnings)
- 4) $\$142 - \$117 = \$25$ (taxable earnings)

You must include \$25 in income as withdrawn earnings not used for qualified education expenses.

Worksheet 5-3, at the end of this chapter, can help you figure your adjusted qualified education expenses, how much of your distribution must be included in income, and the remaining already-taxed amount (basis) in your Coverdell ESAs.

Coordination With Hope and Lifetime Learning Credits

In prior years, the designated beneficiary was required to waive tax-free treatment of the withdrawal from a Coverdell

ESA before a Hope or lifetime learning credit could be claimed. Beginning in 2002, no such waiver is required. An education credit can be claimed in the same year the beneficiary takes a tax-free distribution from a Coverdell ESA, as long as the same expenses are not used for both benefits. Therefore, after the beneficiary reduces qualified higher education expenses by tax-free educational benefits, he or she must further reduce them by the expenses taken into account in determining an education credit.

Example. Derek Green had \$4,200 of qualified higher education expenses for 2002, his first year in college. He paid his college expenses from the following sources.

Partial tuition scholarship (excluded from income on his tax return)	\$1,500
Coverdell ESA withdrawal	1,000
Gift from parents	500
Earnings from part-time job	1,200

Of his \$4,200 of qualified higher education expenses, \$2,700 was tuition and required fees that also qualified for a Hope credit. Derek's parents claimed a \$1,500 Hope credit on their tax return.

Before Derek can determine the taxable portion of his withdrawal, he must reduce his total qualified higher education expenses.

Total qualified higher education expenses	\$4,200
Minus: Tax-free educational benefits	-1,500
Minus: Expenses taken into account in figuring Hope credit	-2,000
Equals: Adjusted qualified higher education expenses	\$ 700

Since the adjusted qualified higher education expenses (\$700) are less than the Coverdell ESA withdrawal, part of the withdrawal will be taxable. The balance in Derek's account before the \$1,000 withdrawal was \$2,800, to which \$2,500 had been contributed. Using the four steps outlined earlier, Derek figures the taxable portion of his withdrawal as shown below.

- 1) $\$1,000 \times (\$2,500 \div \$2,800) = \893 (basis)
- 2) $\$1,000 - \$893 = \$107$ (earnings)
- 3) $\$107 \times (\$700 \div \$1,000) = \75 (tax-free earnings)
- 4) $\$107 - \$75 = \$32$ (taxable earnings)

Derek must include \$32 in income. This represents withdrawn earnings not used for qualified higher education expenses.

Coordination With Qualified Tuition Program (QTP) Withdrawals

Beginning in 2002, if a designated beneficiary takes withdrawals from both a Coverdell ESA and a QTP in the same year, and the total withdrawn is more than the beneficiary's adjusted qualified higher education expenses, those expenses must be allocated between the withdrawal from the Coverdell ESA and the withdrawal from the QTP before figuring how much of each withdrawal is taxable. The following two examples illustrate possible allocations.

Example 1. In 2002, Beatrice graduated from high school and began her first semester of college. That year, she had \$1,000 of qualified elementary and secondary education expenses (QESEE) and \$3,000 of qualified higher education expenses (QHEE). To pay these expenses, Beatrice withdrew \$800 from her Coverdell ESA and \$4,200 from her QTP. No one claimed Beatrice as a dependent, nor was she eligible for an education credit. She did not receive any tax-free educational assistance in 2002. Beatrice must allocate her qualified education expenses between the two withdrawals.

- 1) Beatrice knows that tax-free treatment will be available if she applies her \$800 Coverdell ESA withdrawal toward her \$1,000 of qualified expenses for high school. The qualified expenses are greater than the withdrawal, making the \$800 Coverdell ESA withdrawal tax free.
- 2) Next, Beatrice matches her \$4,200 QTP withdrawal to her \$3,000 of QHEE, and finds she has an excess QTP withdrawal of \$1,200 (\$4,200 QTP – \$3,000 QHEE). She cannot use the extra \$200 of high school expenses (from (1) above) against the QTP withdrawal because those expenses do not qualify a QTP for tax-free treatment.
- 3) Finally, Beatrice figures the taxable and tax-free portions of her QTP withdrawal based on QHEE of \$3,000. (See *Figuring the Taxable Portion*, in chapter 6, for more information.)

Example 2. Assume the same facts as in *Example 1*, except that Beatrice withdrew \$1,800 from her Coverdell ESA and \$3,200 from her QTP. In this case, she allocates her qualified education expenses as follows.

- 1) Using the same reasoning as in *Example 1*, Beatrice matches \$1,000 of her Coverdell ESA withdrawal to her \$1,000 of QESEE — she has \$800 of her withdrawal remaining.
- 2) Because higher education expenses can also qualify a Coverdell ESA withdrawal for tax-free treatment, Beatrice allocates her \$3,000 QHEE between the remaining \$800 Coverdell ESA and the \$3,200 QTP withdrawals (\$4,000 total).

$$\begin{array}{r} \$3,000 \\ \text{expenses} \end{array} \times \frac{\$800 \text{ ESA withdrawal}}{\$4,000 \text{ total withdrawal}} = \$ 600$$

$$\begin{array}{r} \$3,000 \\ \text{expenses} \end{array} \times \frac{\$3,200 \text{ QTP withdrawal}}{\$4,000 \text{ total withdrawal}} = \$2,400$$

- 3) Beatrice then figures the taxable part of her Coverdell ESA withdrawal based on qualified education expenses of \$1,600 (\$1,000 QESEE + \$600 QHEE), and the taxable part of her QTP withdrawal based on QHEE of \$2,400. For Coverdell ESA information, see *Figuring the Taxable Portion of a Withdrawal*, earlier in this chapter. For QTP information, see *Figuring the Taxable Portion*, in chapter 6.



These examples show two types of allocation between withdrawals from a Coverdell ESA and a QTP. However, you do not have to allocate your expenses in the same way. You may use any reasonable method.

Additional Tax on Taxable Withdrawals

Generally, if you receive a taxable withdrawal, you also must pay a 10% additional tax on the amount included in income.

Exceptions. The 10% additional tax does not apply to withdrawals described in the following list.

- 1) Paid to a beneficiary (or to the estate of the designated beneficiary) on or after the death of the designated beneficiary.
- 2) Made because the designated beneficiary is disabled. A person is considered to be disabled if he or she shows proof that he or she cannot do any substantial gainful activity because of his or her physical or mental condition. A physician must determine that his or her condition can be expected to result in death or to be of long-continued and indefinite duration.
- 3) Made because the designated beneficiary received:
 - a) A qualified scholarship excludable from gross income,
 - b) Veterans' educational assistance,
 - c) Employer-provided educational assistance, or
 - d) Any other nontaxable payments (other than gifts, bequests, or inheritances) received for education expenses.
- 4) Included in income only because the qualified education expenses were taken into account in determining the Hope or lifetime learning credit.
- 5) A return of an excess 2002 contribution (and any earnings on it) made before June 1, 2003. The withdrawn earnings must be included in gross income for the year in which the excess contribution was made.

Exception (3) applies only to the extent the withdrawal is not more than the scholarship, allowance, or payment.

Use Part II of Form 5329, *Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts*, to figure any additional tax. Report the amount on Form 1040, line 58.

When Assets Must Be Withdrawn

Any assets remaining in a Coverdell ESA must be withdrawn when either one of the following two events occurs.

- 1) The designated beneficiary reaches age 30. In this case, the designated beneficiary must withdraw the remaining assets within 30 days after reaching age 30. This rule does not apply if the beneficiary is a special needs beneficiary.
- 2) The designated beneficiary dies before reaching age 30. In this case, the remaining assets must generally be withdrawn within 30 days after the date of death.

Exception for Transfer to Surviving Spouse or Family Member

If a Coverdell ESA is transferred to a surviving spouse or other family member as the result of the death of the designated beneficiary, the Coverdell ESA retains its status. (Family member was defined earlier under *Rollovers*.) This means the spouse or other family member can treat the Coverdell ESA as his or her own and does not need to withdraw the assets until he or she reaches age 30. This age limitation does not apply if the new beneficiary is a

special needs beneficiary. There are no tax consequences as a result of the transfer.

How To Figure the Taxable Earnings

Upon withdrawal, the earnings that accumulated tax free in the account must be included in taxable income. You determine these earnings as shown in the following two steps.

- 1) Multiply the amount withdrawn by a fraction. The numerator is the total contributions in the account and the denominator is the total balance in the account before the withdrawal(s).
- 2) Subtract the amount figured in (1) from the total amount withdrawn during the year. The result is the amount of earnings included in the withdrawal. The beneficiary or other person receiving the withdrawal must include this amount in income.

Complete lines A through H on only one worksheet. Complete lines 1 through 15 separately for each of your Coverdell ESAs. Complete the Summary (line 16) on only one worksheet.

Qualified Education Expenses (Complete for total expenses)

- A. Enter your total qualified education expenses for 2002 **A.** _____
- B. Enter those qualified education expenses paid for with tax-free education benefits (for example, scholarships excluded from income, veterans' educational benefits, Pell grants, employer-provided educational assistance) **B.** _____
- C. Enter those qualified higher education expenses deducted on Schedule C or C-EZ (Form 1040), Schedule F (Form 1040), or as a miscellaneous itemized deduction on Schedule A (Form 1040) **C.** _____
- D. Enter those qualified **higher** education expenses on which a Hope or lifetime learning credit was based **D.** _____
- E. Add lines B, C, and D **E.** _____
- F. Subtract line E from line A. This is your adjusted qualified education expense for 2002 **F.** _____
- G. Enter your total withdrawals from **all** Coverdell ESAs during 2002. Do not include rollovers or the return of excess contributions (see instructions) **G.** _____
- H. Divide line F by line G. Enter the result as a decimal (rounded to at least 3 places). If the result is 1.000 or more, enter 1.000 **H.** _____

Taxable Withdrawals and Basis (Complete separately for each account)

- 1. Enter the amount contributed to **this** Coverdell ESA for 2002, including contributions made for 2002 from January 1, 2003, through April 15, 2003. Do **not** include rollovers or the return of excess contributions **1.** _____
 - 2. Enter your basis in this Coverdell ESA as of December 31, 2001 (see instructions) **2.** _____
 - 3. Add lines 1 and 2 **3.** _____
 - 4. Enter the total withdrawals from **this** Coverdell ESA during 2002. Do **not** include rollovers or the return of excess contributions (see instructions) **4.** _____
 - 5. Multiply line 4 by line H. This is the amount of adjusted qualified education expense attributable to this Coverdell ESA **5.** _____
 - 6. Subtract line 5 from line 4 **6.** _____
 - 7. Enter the total value of **this** Coverdell ESA as of December 31, 2002, plus any outstanding rollovers (see instructions) **7.** _____
 - 8. Add lines 4 and 7 **8.** _____
 - 9. Divide line 3 by line 8. Enter the result as a decimal (rounded to at least 3 places). If the result is 1.000 or more, enter 1.000 **9.** _____
 - 10. Multiply line 4 by line 9. This is the amount of basis allocated to your withdrawals, and is tax free **10.** _____
- Note:** If line 6 is zero, skip lines 11 through 13, enter -0- on line 14, and go to line 15.
- 11. Subtract line 10 from line 4 **11.** _____
 - 12. Divide line 5 by line 4. Enter the result as a decimal (rounded to at least 3 places). If the result is 1.000 or more, enter 1.000 **12.** _____
 - 13. Multiply line 11 by line 12. This is the amount of qualified education expenses allocated to your withdrawals, and is tax free **13.** _____
 - 14. Subtract line 13 from line 11. This is the **portion of the withdrawals from this Coverdell ESA in 2002 that you must include in income** **14.** _____
 - 15. Subtract line 10 from line 3. This is your **basis in this Coverdell ESA as of December 31, 2002** **15.** _____

Summary (Complete only once)

- 16. **Taxable amount.** Add together all amounts on line 14 for all your Coverdell ESAs. Enter here and include on Form 1040, line 21, listing the type and amount of income on the dotted line **16.** _____

Worksheet 5–3 Instructions. **Coverdell ESA — Taxable Withdrawals and Basis**

Line G. Enter the total withdrawals received from all Coverdell ESAs during 2002. Do not include amounts rolled over to another ESA within 60 days (only one rollover is allowed during any 12-month period). Also, do not include excess contributions that were distributed with the related earnings (or less any loss) before the first day of the sixth month of the tax year following the year for which the contributions were made.

Line 2. Your basis (amount already taxed) in this Coverdell ESA as of December 31, 2001, is the total of:

- All contributions to this Coverdell ESA before 2002
- Minus the tax-free portion of any withdrawals from this Coverdell ESA before 2002.

If you previously made a withdrawal from this Coverdell ESA, your basis in this account as of the end of the last year in which you took a withdrawal is shown on the last line of the worksheet in the Instructions for Form 8606, *Nondeductible IRAs and Coverdell ESAs*, that you completed for that year. You can determine your basis in this Coverdell ESA as of December 31, 2001, by adding to the basis as of the end of that year any contributions made to that account after the year of the withdrawal and before 2002.

Line 4. Enter the total Coverdell ESA withdrawals received in 2002. Do not include amounts rolled over to another Coverdell ESA within 60 days (only one rollover is allowed during any 12-month period).

Also, do not include excess contributions that were withdrawn with the related earnings (or less any loss) before the first day of the sixth month of the tax year following the year of the contributions.

Line 7. Enter the total value of this Coverdell ESA as of December 31, 2002, plus any outstanding rollovers contributed to the account after 2001, but before the end of the 60-day rollover period. You should receive a statement by January 31, 2003, for each Coverdell ESA showing the value on December 31, 2002.

A **rollover** is a tax-free withdrawal from one Coverdell ESA that is contributed to another Coverdell ESA. An **outstanding rollover** is any amount withdrawn within 60 days before the end of 2002 (November 2 through December 31) that was rolled over after December 31, 2002, but within the 60-day rollover period.

6.

Qualified Tuition Program (QTP)

Important Changes for 2002

Name changed. Qualified state tuition programs (QSTPs) have been renamed qualified tuition programs (QTPs).

Distributions from state-maintained QTPs may be tax free. A distribution from a QTP established and maintained by a state (or an agency or instrumentality of the state) can be excluded from income if the amount distributed is used to pay qualified higher education expenses. For more information, see *Are Distributions Taxable*, in this chapter.

QTPs can be maintained by eligible educational institutions. Beginning in 2002, you can make contributions to a QTP established and maintained by one or more eligible educational institutions. Any earnings distributed before January 1, 2004, will be taxable. For more information, see *What Is a Qualified Tuition Program*, in this chapter.

Tax-free rollovers of QTPs allowed to same beneficiary. Amounts in a QTP can be rolled over, tax free, to another QTP for the same designated beneficiary. However, the tax-free rollover of credits or other amounts from one QTP to another QTP for the benefit of the same beneficiary cannot apply to more than one transfer within any 12-month period.

Definition of family members expanded. For purposes of rollovers and changes of designated beneficiaries, the definition of family members is expanded to include first cousins of the designated beneficiary. For more information, see *Can You Transfer Amounts or Change Beneficiaries*, in this chapter.

Allowed expenses for room and board changed. The limit on the amount that is considered reasonable for room and board expenses has been changed. You must contact the eligible educational institution for its qualified room and board costs. For more information, see *Qualified higher education expenses*, in this chapter.

Certain expenses of special needs students qualify. The definition of *qualified higher education expenses* has been expanded to include expenses of a special needs beneficiary that are necessary in connection with that person's enrollment or attendance at an eligible educational institution. For more information, see *Qualified higher education expenses*, in this chapter.

QTP coordinated with Hope and lifetime learning credits. Beginning in 2002, you may be able to claim a Hope or lifetime learning credit in the same year in which the beneficiary takes a tax-free distribution from a QTP. However, the QTP beneficiary cannot use the same expenses on which the credit is based to figure the nontaxable portion of

the QTP distribution. See *Coordination With Hope and Lifetime Learning Credits*, under *Are Distributions Taxable*, for more information.

The QTP earnings that are taxable only because an education credit was claimed are not subject to the 10% additional tax on taxable withdrawals.

QTP coordinated with Coverdell education savings account (ESA). Beginning in 2002, if a designated beneficiary takes distributions from both a QTP and a Coverdell ESA in the same year, and the total distributed is more than the beneficiary's adjusted qualified higher education expenses, those expenses must be allocated between the distribution from the QTP and the distribution from the Coverdell ESA before figuring how much of each distribution is taxable. For more information, see *Coordination With Coverdell ESA Distributions*, under *Are Distributions Taxable*.

Qualified higher education expenses reduced by tax-free benefits. Beginning in 2002, before you can figure how much of any distribution is tax free, you must determine how much of the qualified higher education expenses have been covered by tax-free educational benefits. Only the remaining expenses are considered covered by the QTP withdrawal(s). See *Adjusted qualified higher education expenses*, under *Figuring the Taxable Portion*, for more information.

Contributions to both QTP and Coverdell ESA allowed in same year. Beginning in 2002, you can make contributions, without penalty, to a QTP even if contributions are also being made to a Coverdell ESA on behalf of the same beneficiary. Before 2002, the contributions to the Coverdell ESA were subject to the additional tax on excess contributions.

Introduction

States may establish and maintain programs that allow you to either prepay or contribute to an account for paying a student's qualified higher education expenses (defined later). Eligible educational institutions may establish and maintain programs that allow you to prepay a student's qualified higher education expenses. If you prepay tuition, the student (designated beneficiary) will be entitled to a waiver or a payment of qualified higher education expenses. You cannot deduct either payments or contributions to a QTP. For information on a specific QTP, you will need to contact the state agency or eligible educational institution that established and maintains it.

In 2001 and earlier years, tax was due on the part of a distribution that represented earnings on the payments or contributions. Beginning with distributions in 2002, however, no tax will be due on a distribution from a state-sponsored QTP unless the distribution is greater than the beneficiary's adjusted qualified higher education expenses. See *Are Distributions Taxable*, later, for more information.

Note. Even if a QTP is used to finance a student's higher education, the student or the student's parents still may be eligible to claim either the Hope credit or the lifetime learning credit.

What Is a Qualified Tuition Program?

A qualified tuition program (also known as a 529 plan or program) is a program set up to allow you to either prepay, or contribute to an account established for paying, a student's **qualified higher education expenses** at an **eligible educational institution**. Prior to 2002, a program could only be established and maintained by a state or an agency or instrumentality of the state. Beginning in 2002, QTPs (formerly called QSTPs) can also be established and maintained by eligible educational institutions. The program must meet certain requirements. Your state government or the eligible educational institution in which you are interested can tell you whether or not they participate in a QTP.

Qualified higher education expenses. These expenses are the tuition, fees, books, supplies, and equipment required for enrollment or attendance at an eligible educational institution (defined below).

They also include the reasonable costs of room and board for a **designated beneficiary** who is at least a half-time student. The cost of room and board qualifies only to the extent that it is not more than the greater of the following two amounts.

- 1) The allowance for room and board, as determined by the eligible educational institution, that was included in the cost of attendance (for federal financial aid purposes) for a particular academic period and living arrangement of the student.
- 2) The actual amount charged if the student is residing in housing owned or operated by the eligible educational institution.

You will need to contact the eligible educational institution for qualified room and board costs.

Beginning in 2002, the definition of qualified higher education expenses is expanded to include expenses of a special needs beneficiary that are necessary for that person's enrollment or attendance at an eligible educational institution.



*As of this printing, regulations defining a **special needs beneficiary** have not been released. If available, the definition will be included in Publication 553, Highlights of 2002 Tax Changes, which will be issued in early 2003.*

Designated beneficiary. The designated beneficiary is generally the student (or future student) for whom the QTP is intended to provide benefits. The designated beneficiary can be changed after participation in the QTP begins. If a state or local government or certain tax-exempt organizations purchase an interest in a QTP as part of a scholarship program, the designated beneficiary is the person who receives the interest as a scholarship.

Eligible educational institution. This is any college, university, vocational school, or other postsecondary educational institution eligible to participate in a student aid program administered by the Department of Education. It

includes virtually all accredited public, nonprofit, and proprietary (privately owned profit-making) postsecondary institutions. The educational institution should be able to tell you if it is an eligible educational institution.

How Much Can You Contribute?

Contributions to a QTP on behalf of any beneficiary cannot be more than the amount necessary to provide for the qualified higher education expenses of the beneficiary. There are no income restrictions on the individual contributors.

Beginning in 2002, you can contribute to both a QTP and a Coverdell ESA in the same year for the same designated beneficiary. Your Coverdell ESA contribution is not considered an excess contribution.

Are Distributions Taxable?

The part of a distribution representing the amount paid or contributed to a QTP does not have to be included in income. This is a return of the investment in the plan.

Beginning in 2002, the beneficiary generally does not have to include in income any earnings distributed from a QTP established and maintained by a state (or an agency or instrumentality of the state) if the total distribution is less than or equal to adjusted qualified higher education expenses (defined under *Figuring the Taxable Portion*, later). However, until 2004, the beneficiary must include in income any earnings distributed from a QTP established and maintained by an eligible educational institution.

Earnings and return of investment. You will receive a **Form 1099-Q, Qualified Tuition Program Payments (Under Section 529)**, from each of the programs from which you received a QTP distribution in 2002. The amount of your gross distribution (box 1) shown on each form will be divided between your earnings (box 2) and your basis, or return of investment (box 3). Form 1099-Q must be issued by January 31, 2003.

Figuring the Taxable Portion

To determine if total distributions for the year are more or less than the amount of qualified expenses, you must compare the total of all QTP distributions for the tax year to the **adjusted qualified higher education expenses**.

Adjusted qualified higher education expenses. This amount is the total qualified higher education expenses reduced by any tax-free educational assistance. Tax-free educational assistance could include:

- Scholarships that are excluded from gross income,
- Veterans' educational assistance,
- Pell grants,
- Employer-provided educational assistance, and
- Any other nontaxable payments (other than gifts, bequests, or inheritances) received for education expenses.

Taxable earnings. Use the following steps to figure the taxable part.

- 1) Multiply the total distributed earnings shown on Form 1099–Q by a fraction. The numerator is the adjusted qualified higher education expenses paid during the year and the denominator is the total amount distributed during the year.
- 2) Subtract the amount figured in (1) from the total earnings. This is the amount the beneficiary must include in income. Report it on line 21, Form 1040.

Example. In 1996, Sara Clarke’s parents opened a savings account for her, with a QTP maintained by their state government. Over the years they contributed \$18,000 to the account. The total balance in the account is \$27,000 on the date the distribution is made. In the summer of 2002, Sara enrolled in college and had \$6,500 of qualified higher education expenses for the rest of the year. She paid her college expenses from the following sources.

Partial tuition scholarship	\$3,000
QTP distribution	3,600

Before Sara can determine the taxable part of her QTP distribution, she must reduce her total qualified higher education expenses.

Total qualified higher education expenses	\$6,500
Minus: Tax-free educational benefits	<u>–3,000</u>
Equals: Adjusted qualified higher education expenses	\$3,500

Since the remaining expenses (\$3,500) are less than the QTP distribution, part of the earnings will be taxable.

Sara’s Form 1099–Q shows that \$1,200 of the QTP distribution is earnings. Sara figures the taxable part of the distributed earnings as follows.

- 1) $\$1,200 \text{ distributed earnings} \times (\$3,500 \text{ expenses} \div \$3,600 \text{ distribution}) = \$1,166 \text{ tax-free earnings}$
- 2) $\$1,200 - \$1,166 = \$34 \text{ taxable earnings}$

Sara must include \$34 in income as distributed QTP earnings not used for adjusted qualified higher education expenses.

Coordination With Hope and Lifetime Learning Credits

A Hope or lifetime learning credit (education credit) can be claimed in the same year the beneficiary takes a tax-free distribution from a QTP, as long as the same expenses are not used for both benefits. This means that after the beneficiary reduces qualified higher education expenses by tax-free educational benefits, he or she must further reduce them by the expenses taken into account in determining the credit.

Example. Assume the same facts for Sara Clarke as in the previous example, except that Sara’s parents claimed a Hope credit of \$1,500.

Total qualified higher education expenses	\$6,500
Minus: Tax-free educational benefits	<u>–3,000</u>
Minus: Expenses taken into account in figuring Hope credit	<u>–2,000</u>
Equals: Adjusted qualified higher education expenses	\$1,500

The taxable part of the distribution is figured as follows.

- 1) $\$1,200 \text{ distributed earnings} \times (\$1,500 \text{ expenses} \div \$3,600 \text{ distribution}) = \$500 \text{ tax-free earnings}$
- 2) $\$1,200 - \$500 = \$700 \text{ taxable earnings}$

Sara must include \$700 in income. This represents distributed earnings not used for adjusted qualified higher education expenses.

Coordination With Coverdell ESA Distributions

If a designated beneficiary receives distributions from both a QTP and a Coverdell ESA, and the total of these distributions is more than the adjusted qualified higher education expenses, the expenses must be allocated between the distributions.

Example. Assume the same facts as in the last example for Sara Clarke, except that instead of withdrawing \$3,600 from her QTP, Sara withdrew \$3,000 from that account and \$600 from her Coverdell ESA. In this case, Sara must allocate the adjusted qualified higher education expenses (\$1,500) between the two distributions.

$$\begin{aligned} & \$1,500 \text{ expenses} \times \frac{\$600 \text{ ESA distribution}}{\$3,600 \text{ total distribution}} = \$250 \\ & \$1,500 \text{ expenses} \times \frac{\$3,000 \text{ QTP distribution}}{\$3,600 \text{ total distribution}} = \$1,250 \end{aligned}$$

Sara then figures the taxable portion of her Coverdell ESA distribution based on qualified education expenses of \$250, and the taxable portion of her QTP distribution based on the other \$1,250.

Note. If you are required to allocate your expenses between Coverdell ESA and QTP distributions, and you have adjusted qualified elementary and secondary education expenses, see the example in chapter 5 under *Coordination With Qualified Tuition Program (QTP) Withdrawals*.

Additional Tax on Taxable Distributions

Generally, if you receive a taxable distribution, you also must pay a 10% additional tax on the amount included in income.

Exceptions. The 10% additional tax does not apply to distributions described in the following list.

- 1) Paid to a beneficiary (or to the estate of the designated beneficiary) on or after the death of the designated beneficiary.
- 2) Made because the designated beneficiary is disabled. A person is considered to be disabled if he or

she shows proof that he or she cannot do any substantial gainful activity because of his or her physical or mental condition. A physician must determine that his or her condition can be expected to result in death or to be of long-continued and indefinite duration.

- 3) Made because the designated beneficiary received:
 - a) A qualified scholarship excludable from gross income,
 - b) Veterans' educational assistance,
 - c) Employer-provided educational assistance, or
 - d) Any other nontaxable payments (other than gifts, bequests, or inheritances) received for education expenses.
- 4) Included in income only because the qualified education expenses were taken into account in determining the Hope or lifetime learning credit.
- 5) Made before 2004 and used for qualified higher education expenses, but included in income because it was paid from a QTP established and maintained by an eligible educational institution.

Exception (3) applies only to the extent the withdrawal is not more than the scholarship, allowance, or payment.

Use Part II of Form 5329, *Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts*, to figure any additional tax. Report the amount on Form 1040, line 58.

Losses on QTP Investments

If you have a loss on your investment in a QTP account, you can take the loss on your income tax return, but only when all amounts from that account have been distributed and the total distributions are less than your unrecovered basis. Your basis is the total amount of contributions to that QTP account. You claim the loss as a miscellaneous itemized deduction on line 22 of Schedule A (Form 1040), subject to the 2%-of-adjusted-gross-income limit.

Can You Transfer Amounts or Change Beneficiaries?

Amounts in a QTP can be transferred or rolled over tax free to the QTP of another beneficiary. The transfer or rollover must be completed within 60 days of the distribution and the new beneficiary must be a member of the same family (defined later) as the original designated beneficiary.

Starting in 2002, amounts in a QTP of one beneficiary can be transferred or rolled over tax free to another QTP for the same beneficiary. However, a tax-free transfer or rollover cannot be made more than once within any 12-month period with respect to the same beneficiary.

The beneficiary of a QTP can be changed without transferring accounts. However, the new beneficiary must be one of the family members listed next.

Family members. The amounts in a QTP can be transferred tax free to the designated beneficiary's spouse or any of the following other members of the beneficiary's family.

- 1) Son or daughter or descendant of son or daughter.
- 2) Stepson or stepdaughter.
- 3) Brother, sister, stepbrother, or stepsister.
- 4) Father or mother or ancestor of either.
- 5) Stepfather or stepmother.
- 6) Son or daughter of a brother or sister.
- 7) Brother or sister of father or mother.
- 8) Son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law.
- 9) The spouse of any individual listed above.
- 10) First cousin.

7.

Early Withdrawals From IRAs

Important Changes for 2002

Qualified education expenses expanded. The definition of qualified higher education expenses has been expanded to include certain expenses for special needs students.

Allowed expenses for room and board changed. The limit on the amount that is considered reasonable for room and board expenses has been changed. You must contact the educational institution for its qualified room and board costs. For more information, see *Qualified higher education expenses*.

Introduction

Generally, if you make withdrawals from your IRA before you reach age 59½, you must pay a 10% additional tax on the early withdrawal. This applies to any IRA you own, whether it is a traditional IRA (including a SEP-IRA), a Roth IRA, or a SIMPLE IRA. Publication 590, *Individual Retirement Arrangements (IRAs)*, has more information about these IRAs.

However, you can make withdrawals from your IRAs for **qualified higher education expenses** without having to pay the 10% additional tax. You will owe income tax on at least part of the amount withdrawn, but you will not have to pay the 10% additional tax on early withdrawals.

The part not subject to the additional tax is generally the amount that is not more than the adjusted qualified higher education expenses for the year.

Who Can Make Early Withdrawals Free of the 10% Tax?

You can make a withdrawal from your IRA before you reach age 59½ and not have to pay the 10% additional tax if, for the year of the withdrawal, you pay **qualified higher education expenses** for yourself, your spouse, or you or your spouse's children or grandchildren.

Qualified higher education expenses. These expenses are tuition, fees, books, supplies, and equipment required for enrollment or attendance at an **eligible educational institution**. Beginning in 2002, they also include expenses for special needs services incurred by or for special needs students in connection with their enrollment or attendance.



As of this printing, regulations defining a **special needs beneficiary** have not been released. If available, the definition will be included in Publication 553, Highlights of 2002 Tax Changes, which will be issued in early 2003.

In addition, if the student is at least a **half-time student**, room and board are qualified higher education expenses.

The expense for room and board qualifies only to the extent that it is not more than the greater of the following two amounts.

- 1) The allowance for room and board, as determined by the eligible educational institution, that was included in the cost of attendance (for federal financial aid purposes) for a particular academic period and living arrangement of the student.
- 2) The actual amount charged if the student is residing in housing owned or operated by the eligible educational institution.

Eligible educational institution. An eligible educational institution is any college, university, vocational school, or other postsecondary educational institution eligible to participate in a student aid program administered by the Department of Education. It includes virtually all accredited, public, nonprofit, and proprietary (privately owned profit-making) postsecondary institutions. The educational institution should be able to tell you if it is an eligible educational institution.

Half-time student. A student is enrolled "at least half-time" if he or she is enrolled for at least half the full-time academic work load for the course of study the student is pursuing as determined under the standards of the school where the student is enrolled.

How Do You Figure the Amount Not Subject to the 10% Tax?

When determining the amount of the withdrawal that is not subject to the 10% additional tax, first find your **adjusted qualified higher education expenses**. You do this by reducing your total qualified expenses by any expenses paid with the following funds.

- 1) Tax-free withdrawals from a Coverdell ESA (formerly known as an education IRA).
- 2) Tax-free scholarships.
- 3) Tax-free employer-provided educational assistance.
- 4) Any tax-free payment (other than a gift, bequest, or devise) due to enrollment at an eligible educational institution.

Do not reduce the total by any expenses paid with the following funds.

- 1) An individual's earnings.
- 2) A loan.
- 3) A gift.
- 4) An inheritance given to either the student or the individual making the withdrawal.

- 5) Personal savings (including savings from a qualified tuition program).

After determining the adjusted amount of qualified higher education expenses, compare that amount to the amount of the IRA withdrawal to determine how much, if any, of the withdrawal is subject to the 10% additional tax.

8.

Education Savings Bond Program

Important Changes for 2002

New modification to adjusted gross income (AGI). Beginning in 2002, for purposes of the phaseout of the deduction, you must add back to your AGI any qualified tuition and fees deducted on Form 1040 or 1040A. Your modified adjusted gross income (MAGI) is your AGI without excluding your savings bond interest and with certain other deductions and exclusions added back in. For more information, see *Modified adjusted gross income (MAGI)* under *Who Can Cash In Bonds Tax Free*.

Income limits for exclusion reduction increased. For 2002, the amount of your interest exclusion will be phased out (gradually reduced) if your filing status is married filing jointly or qualifying widow(er) **and** if your MAGI is between \$86,400 and \$116,400. You cannot take the deduction if your MAGI is \$116,400 or more. For 2001, the limits that applied to you were \$83,650 and \$113,650.

For all other filing statuses, your interest exclusion is phased out if your MAGI is between \$57,600 and \$72,600. You cannot take the deduction if your MAGI is \$72,600 or more. For 2001, the limits that applied to you were \$55,750 and \$70,750. See *Does the Amount of Your Income Affect the Amount of Your Exclusion*, later.

Qualified higher education expenses may be further reduced. Beginning in 2002, you must reduce your qualified higher education expenses by the expenses you used to figure the exclusion of earnings from a qualified tuition program (QTP). For more information, see *Expenses reduced by certain benefits* under *Qualified higher education expenses*.

Introduction

Generally, you must pay tax on the interest earned on U.S. savings bonds. If you do not include the interest in income in the years it is earned, you must include it in your income in the year in which you cash in the bonds.

However, when you cash in certain savings bonds under an education savings bond program, you may be able to exclude interest from income.

Who Can Cash In Bonds Tax Free?

You may be able to cash in **qualified U.S. savings bonds** without having to include in your income some or all of the interest earned on the bonds if you meet the following conditions.

- You pay **qualified higher education expenses** for yourself, your spouse, or a **dependent for whom you claim an exemption** on your return.
- Your **modified adjusted gross income (MAGI)** is less than \$72,600 (\$116,400 if filing a joint return).
- Your filing status is not married filing separately.

Qualified U.S. savings bonds. A qualified U.S. savings bond is a series EE bond **issued after 1989** or a series I bond. The bond must be issued either in your name (as the sole owner) or in the name of both you and your spouse (as co-owners).

The owner must be at least 24 years old before the bond's issue date. The issue date is printed directly on the front of the savings bond.



The issue date is not necessarily the date of purchase — it will be the first day of the month in which the bond is purchased.

Qualified higher education expenses. These include the following items you pay for either yourself, your spouse, or a dependent for whom you claim an exemption.

- 1) Tuition and fees required to enroll at or attend an **eligible educational institution**. Qualified expenses do **not** include expenses for room and board or for courses involving sports, games, or hobbies that are not part of a degree or certificate granting program.
- 2) Contributions to a qualified tuition program (QTP) (see chapter 6).
- 3) Contributions to a Coverdell education savings account (ESA), formerly known as an education IRA (see chapter 5).

Adjusted qualified higher education expenses. You must reduce your qualified higher education expenses by all of the following tax-free benefits.

- 1) Tax-free scholarships. See Publication 520.
- 2) Expenses used to figure the tax-free portion of withdrawals from a Coverdell ESA (formerly known as an education IRA).
- 3) Expenses used to figure the tax-free portion of distributions from a QTP.
- 4) Any nontaxable payments (other than gifts, bequests, or inheritances) received for education expenses or for attending an eligible educational institution, such as:
 - a) Veterans' educational assistance benefits,
 - b) Qualified tuition reductions, or
 - c) Employer-provided educational assistance.
- 5) Any expenses used in figuring the Hope and lifetime learning credits.

Eligible educational institution. An eligible educational institution is any college, university, vocational school, or other postsecondary educational institution eligible to participate in a student aid program administered by the Department of Education. It includes virtually all accredited, public, nonprofit, and proprietary (privately owned profit-making) postsecondary institutions. The educational institution should be able to tell you if it is an eligible educational institution.

Dependent for whom you claim an exemption. You claim an exemption for a person if you list his or her name and other required information on line 6c, Form 1040 (or Form 1040A).

Modified adjusted gross income (MAGI). For most taxpayers, MAGI is adjusted gross income (AGI) as figured on their federal income tax return without taking into account this interest exclusion.

MAGI when using Form 1040A. If you file Form 1040A, MAGI is the AGI on line 22 of that form figured without taking into account any savings bond interest exclusion and modified by adding back any:

- 1) Exclusion for adoption benefits received under an employer's adoption assistance program,
- 2) Deduction for student loan interest, and
- 3) Deduction for tuition and fees.

MAGI when using Form 1040. If you file Form 1040, your MAGI is the AGI on line 36 of that form figured without taking into account any savings bond interest exclusion and modified by adding back any:

- 1) Foreign earned income exclusion,
- 2) Foreign housing exclusion,
- 3) Foreign housing deduction,
- 4) Exclusion of income for bona fide residents of American Samoa,
- 5) Exclusion of income from Puerto Rico,
- 6) Exclusion for adoption benefits received under an employer's adoption assistance program,
- 7) Deduction for student loan interest, and
- 8) Deduction for tuition and fees

Use the worksheet in the instructions for line 9, **Form 8815**, to figure your MAGI. If you claim any of the exclusion or deduction items (1) – (6) listed above, add the amount of the exclusion or deduction to the amount on line 5 of the worksheet. Do **not** add in the deduction for (7) student loan interest or (8) tuition and fees. Enter the total on Form 8815, line 9, as your modified AGI.



Because the deduction for interest expenses attributable to royalties and other investments is limited to your net investment income, you cannot figure the deduction until you have figured this interest

exclusion. Therefore, if you had interest expenses attributable to royalties and deductible on Schedule E (Form 1040), Supplemental Income and Loss, you must make a special computation of your deductible interest without regard to this exclusion to figure the net royalty income included in your modified AGI. See Royalties included in modified AGI under Education Savings Bond Program in chapter 1 of Publication 550.

How Is the Tax-Free Amount Figured?

If the total you receive when you cash in the bonds is not more than the adjusted qualified higher education expenses for the year, all of the interest on the bonds may be tax free. However, if the total you receive when you cash in the bonds is more than the adjusted expenses, only part of the interest may be tax free.

To determine the tax-free amount, multiply the interest part of the proceeds by a fraction. The numerator (top part) of the fraction is the adjusted qualified higher education expenses you paid during the year. The denominator (bottom part) of the fraction is the total proceeds you received during the year.

Example. In February 2002, Mark and Joan Washington, a married couple, cashed a qualified series EE U.S. savings bond they bought in November 1993. They received proceeds of \$9,000, representing principal of \$6,000 and interest of \$3,000. In 2002, they paid \$7,500 of their daughter's college tuition. They are not claiming an education credit for that amount, and their daughter does not have any tax-free education benefits. Their MAGI for 2002 was \$80,000.

$$\begin{array}{r} \$3,000 \\ \text{interest} \end{array} \times \frac{\begin{array}{r} \$7,500 \text{ expenses} \\ \$9,000 \text{ proceeds} \end{array}}{\begin{array}{r} \$9,000 \text{ proceeds} \end{array}} = \begin{array}{r} \$2,499 \text{ tax-free} \\ \text{interest} \end{array}$$

They can exclude \$2,499 of interest in 2002. They must pay tax on the remaining \$501 (\$3,000 – \$2,499) interest.

Does the Amount of Your Income Affect the Amount of Your Exclusion?

The amount of your interest exclusion is gradually reduced (phased out) if your modified adjusted gross income is between \$57,600 and \$72,600 (between \$86,400 and \$116,400 if your filing status is married filing jointly or qualifying widow(er)). You cannot exclude any of the interest if your modified adjusted gross income is equal to or more than the upper limit.

The phaseout, if any, is figured for you when you fill out Form 8815.

Illustrated example. The information is the same as in the previous example for Mark and Joan Washington, except they have a modified adjusted gross income of \$104,400. In this example, they can exclude \$1,000 (line 14 of Form 8815 shown at the end of this chapter) of interest in 2002.

They must pay tax on the remaining \$2,000 interest (\$3,000 total interest minus \$1,000 excluded interest).

How Is the Exclusion Claimed?

Use Form 8815 to figure your education savings bond interest exclusion. Attach the form to your Form 1040 or 1040A.

**Exclusion of Interest From Series EE and I
 U.S. Savings Bonds Issued After 1989
 (For Filers With Qualified Higher Education Expenses)**
 Attach to Form 1040 or Form 1040A.

Name(s) shown on return
 Mark & Joan Washington

Your social security number
 000 : 00 : 4567

1 (a) Name of person (you, your spouse, or your dependent) who was enrolled at or attended an eligible educational institution	(b) Name and address of eligible educational institution
Anna Washington	Jamestown University Normal, VA 20100

If you need more space, attach a statement.

2 Enter the total qualified higher education expenses you paid in 2002 for the person(s) listed in column (a) of line 1. See the instructions to find out which expenses qualify	2	7,500	
3 Enter the total of any nontaxable educational benefits (such as nontaxable scholarship or fellowship grants) received for 2002 for the person(s) listed in column (a) of line 1 (see instructions)	3	0	
4 Subtract line 3 from line 2. If zero or less, stop . You cannot take the exclusion	4	7,500	
5 Enter the total proceeds (principal and interest) from all series EE and I U.S. savings bonds issued after 1989 that you cash during 2002	5	9,000	
6 Enter the interest included on line 5 (see instructions)	6	3,000	
7 If line 4 is equal to or more than line 5, enter "1.000." If line 4 is less than line 5, divide line 4 by line 5. Enter the result as a decimal (rounded to at least three places)	7	× . 833	
8 Multiply line 6 by line 7	8	2,499	
9 Enter your modified adjusted gross income (see instructions) Note: If line 9 is \$72,600 or more if single or head of household, or \$116,400 or more if married filing jointly or qualifying widow(er), stop . You cannot take the exclusion.	9	104,400	
10 Enter: \$57,600 if single or head of household; \$86,400 if married filing jointly or qualifying widow(er)	10	86,400	
11 Subtract line 10 from line 9. If zero or less, skip line 12, enter -0- on line 13, and go to line 14	11	18,000	
12 Divide line 11 by: \$15,000 if single or head of household; \$30,000 if married filing jointly or qualifying widow(er). Enter the result as a decimal (rounded to at least three places)	12	× . 600	
13 Multiply line 8 by line 12	13	1,499	
14 Excludable savings bond interest. Subtract line 13 from line 8. Enter the result here and on Schedule B (Form 1040), line 3, or Schedule 1 (Form 1040A), line 3, whichever applies	14	1,000	

General Instructions

Section references are to the Internal Revenue Code.

Purpose of Form

If you cashed series EE or I U.S. savings bonds in 2002 that were issued after 1989, you may be able to exclude from your income part or all of the interest on those bonds. Use this form to figure the amount of any interest you may exclude.

Who May Take the Exclusion

You may take the exclusion if **all four** of the following apply.

1. You cashed qualified U.S. savings bonds in 2002 that were issued after 1989.
2. You paid qualified higher education expenses in 2002 for yourself, your spouse, or your dependents.
3. Your filing status is any status **except** married filing separately.
4. Your modified AGI (adjusted gross income) is less than: \$72,600 if single or head of household; \$116,400 if married filing jointly or qualifying widow(er). See the instructions for line 9 to figure your modified AGI.

U.S. Savings Bonds That Qualify for Exclusion

To qualify for the exclusion, the bonds must be series EE or I U.S. savings bonds issued after 1989 in your name, or, if you are married, they may be issued in your name and your spouse's name. Also, you must have been age 24 or older before the bonds were issued. A bond bought by a parent and issued in the name of his or her child under age 24 does not qualify for the exclusion by the parent or child.

Recordkeeping Requirements

Keep the following records to verify interest you exclude.

- Bills, receipts, canceled checks, or other documents showing you paid qualified higher education expenses in 2002.
- A written record of each post-1989 series EE or I bond that you cash. Your record must include the serial number, issue date, face value, and total redemption proceeds (principal and interest) of each bond. You may use **Form 8818, Optional Form To Record Redemption of Series EE and I U.S. Savings Bonds Issued After 1989.**

9.

Employer-Provided Educational Assistance

Important Change for 2002

The tax-free status of up to \$5,250 of employer-provided educational assistance benefits each year has been extended through 2010. Beginning in 2002, it applies to both undergraduate- and graduate-level courses.

Introduction

Your employer may be able to provide you, tax free, up to \$5,250 of education benefits each year. 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 payments do not have to be for work-related courses.

Your employer will be able to tell you whether the benefits are tax free.



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 credit and the lifetime learning credit.

Education benefits. Education benefits that your employer can provide tax free include payments for tuition, fees and similar expenses, books, supplies, and equipment. Beginning in 2002, these payments can be for either undergraduate- or graduate-level courses. The payments do not have to be for work-related courses.

Educational assistance benefits do not include payments for the following items.

- 1) Meals, lodging, transportation, or tools or supplies (other than textbooks) that you can keep after completing the course of instruction.
- 2) Courses involving sports, games, or hobbies unless they:
 - a) Have a reasonable relationship to the business of your employer, or
 - b) Are required as part of a degree program.

Benefit over \$5,250. If your employer pays for more than \$5,250 of education benefits for you during the year, you must generally pay tax on the amount over \$5,250. Your employer should include in your wages (box 1 of your Form W-2) the amount that you must include in income.

Working condition fringe benefit. However, if the payments also qualify as a working condition fringe benefit, your employer does not have to include them in your wages. A working condition fringe benefit is a benefit which, had you paid for it, you could deduct as an employee business expense. For more information on working condition fringe benefits, see *Working Condition Benefits* in chapter 2 of Publication 15-B, *Employer's Tax Guide to Fringe Benefits*.

10.

How To Get Tax Help

You can get help with unresolved tax issues, order free publications and forms, ask tax questions, and get more information from the IRS in several ways. By selecting the method that is best for you, you will have quick and easy access to tax help.

Contacting your Taxpayer Advocate. If you have attempted to deal with an IRS problem unsuccessfully, you should contact your Taxpayer Advocate.

The Taxpayer Advocate represents your interests and concerns within the IRS by protecting your rights and resolving problems that have not been fixed through normal channels. While Taxpayer Advocates cannot change the tax law or make a technical tax decision, they can clear up problems that resulted from previous contacts and ensure that your case is given a complete and impartial review.

To contact your Taxpayer Advocate:

- Call the Taxpayer Advocate at **1-877-777-4778**.
- Call, write, or fax the Taxpayer Advocate office in your area.
- Call **1-800-829-4059** if you are a TTY/TDD user.

For more information, see Publication 1546, *The Taxpayer Advocate Service of the IRS*.

Free tax services. To find out what services are available, get Publication 910, *Guide to Free Tax Services*. It contains a list of free tax publications and an index of tax topics. It also describes other free tax information services, including tax education and assistance programs and a list of TeleTax topics.



Personal computer. With your personal computer and modem, you can access the IRS on the Internet at **www.irs.gov**. While visiting our web site, you can:

- See answers to frequently asked tax questions or request help by e-mail.
- Download forms and publications or search for forms and publications by topic or keyword.
- Order IRS products on-line.
- View forms that may be filled in electronically, print the completed form, and then save the form for recordkeeping.
- View Internal Revenue Bulletins published in the last few years.
- Search regulations and the Internal Revenue Code.
- Receive our electronic newsletters on hot tax issues and news.
- Learn about the benefits of filing electronically (IRS e-file).
- Get information on starting and operating a small business.

You can also reach us with your computer using File Transfer Protocol at **ftp.irs.gov**.



TaxFax Service. Using the phone attached to your fax machine, you can receive forms and instructions by calling **703-368-9694**. Follow the directions from the prompts. When you order forms, enter the catalog number for the form you need. The items you request will be faxed to you.

For help with transmission problems, call the FedWorld Help Desk at **703-487-4608**.



Phone. Many services are available by phone.

- *Ordering forms, instructions, and publications.* Call **1-800-829-3676** to order current and prior year forms, instructions, and publications.
- *Asking tax questions.* Call the IRS with your tax questions at **1-800-829-1040**.
- *Solving problems.* Take advantage of Everyday Tax Solutions service by calling your local IRS office to set up an in-person appointment at your convenience. Check your local directory assistance or **www.irs.gov** for the numbers.
- *TTY/TDD equipment.* If you have access to TTY/TDD equipment, call **1-800-829-4059** to ask tax questions or to order forms and publications.
- *TeleTax topics.* Call **1-800-829-4477** to listen to pre-recorded messages covering various tax topics.

Evaluating the quality of our telephone services. To ensure that IRS representatives give accurate, courteous, and professional answers, we use several methods to evaluate the quality of our telephone services. One method is for a second IRS representative to sometimes listen in on or record telephone calls. Another is to ask some callers to complete a short survey at the end of the call.



Walk-in. Many products and services are available on a walk-in basis.

- *Products.* You can walk in to many post offices, libraries, and IRS offices to pick up certain forms, instructions, and publications. Some IRS offices, libraries, grocery stores, copy centers, city and county governments, credit unions, and office supply stores have an extensive collection of products available to print from a CD-ROM or photocopy from reproducible proofs. Also, some IRS offices and libraries have the Internal Revenue Code, regulations, Internal Revenue Bulletins, and Cumulative Bulletins available for research purposes.
- *Services.* You can walk in to your local IRS office to ask tax questions or get help with a tax problem. Now you can set up an appointment by calling your local IRS office number and, at the prompt, leaving a

message requesting Everyday Tax Solutions help. A representative will call you back within 2 business days to schedule an in-person appointment at your convenience.



Mail. You can send your order for forms, instructions, and publications to the Distribution Center nearest to you and receive a response within 10 workdays after your request is received. Find the address that applies to your part of the country.

- **Western part of U.S.:**
Western Area Distribution Center
Rancho Cordova, CA 95743-0001
- **Central part of U.S.:**
Central Area Distribution Center
P.O. Box 8903
Bloomington, IL 61702-8903
- **Eastern part of U.S. and foreign addresses:**
Eastern Area Distribution Center
P.O. Box 85074
Richmond, VA 23261-5074



CD-ROM for tax products. You can order IRS Publication 1796, *Federal Tax Products on CD-ROM*, and obtain:

- Current tax forms, instructions, and publications.
- Prior-year tax forms and instructions.

- Popular tax forms that may be filled in electronically, printed out for submission, and saved for record-keeping.
- Internal Revenue Bulletins.

The CD-ROM can be purchased from National Technical Information Service (NTIS) by calling **1-877-233-6767** or on the Internet at **<http://www.irs.gov/cdorders>**. The first release is available in early January and the final release is available in late February.



CD-ROM for small businesses. IRS Publication 3207, *Small Business Resource Guide*, is a must for every small business owner or any taxpayer about to start a business. This handy, interactive CD contains all the business tax forms, instructions and publications needed to successfully manage a business. In addition, the CD provides an abundance of other helpful information, such as how to prepare a business plan, finding financing for your business, and much more. The design of the CD makes finding information easy and quick and incorporates file formats and browsers that can be run on virtually any desktop or laptop computer.

It is available in March. You can get a free copy by calling **1-800-829-3676** or by visiting the website at **www.irs.gov/smallbiz**.

Appendices

The following appendices include an illustrated example of how to use the Form 8863 when claiming both education tax credits at the same time and a chart reflecting some of the major differences between the many tax benefits for higher education that are outlined in this publication.

- 1) **Appendix A**— *An Illustrated Example of Education Credits* including a filled-in Form 8863 showing how to claim both the Hope credit and lifetime learning credit for 2002.
- 2) **Appendix B**— A chart summarizing *some* of the differences between the different higher education tax benefits discussed in this publication. It is intended only as a guide. Look in this publication for more complete information.

Appendix A. Illustrated Example of Education Credits

Dave and Valerie Jones are married and file a joint tax return. For 2002, they claim exemptions for their two dependent children on their tax return. Their modified adjusted gross income is \$84,000. Their tax, before credits, is \$10,625. Their son, Sean, will receive his bachelor's degree in psychology from the state college in May 2003. Their daughter, Corey, enrolled full-time at that same college in August 2001 to begin working on her bachelor's degree in physical education. In July 2002, Dave and Valerie paid \$2,200 in tuition costs for each child for the Fall 2002 semester.

Dave and Valerie, their children, and the college meet all of the requirements for the higher education credits.

Because Sean is beyond the second (sophomore) year of his postsecondary education, his expenses do not qualify for the Hope credit. But, amounts paid for Sean's expenses in 2002 for academic periods beginning in 2002 qualify for the lifetime learning credit. Corey is in her first two (freshman and sophomore) years of postsecondary education and expenses paid for her in 2002 for academic periods beginning in 2002 qualify for the Hope credit.

Dave and Valerie figure their tentative education credits for 2002, \$1,940, as shown in the completed Form 8863. They cannot claim the full amount because their modified adjusted gross income is more than \$82,000. They carry the amount from line 18 of Form 8863 to line 48 of Form 1040, and they attach the Form 8863 to their return. ■

Appendix A (Continued)

Form **8863**
 Department of the Treasury
 Internal Revenue Service
 Name(s) shown on return

Education Credits
(Hope and Lifetime Learning Credits)

▶ See instructions.
 ▶ Attach to Form 1040 or Form 1040A.

OMB No. 1545-1618

2002
 Attachment
 Sequence No. **50**

Your social security number
 987 : 00 : 6543

Dave and Valerie Jones

Part I Hope Credit. Caution: The Hope credit may be claimed for no more than 2 tax years for the same student.

1	(a) Student's name (as shown on page 1 of your tax return) First name Last name	(b) Student's social security number (as shown on page 1 of your tax return)	(c) Qualified expenses (but do not enter more than \$2,000 for each student). See instructions	(d) Enter the smaller of the amount in column (c) or \$1,000	(e) Subtract column (d) from column (c)	(f) Enter one-half of the amount in column (e)	
	Corey Jones	137 : 00 : 9642	2,000	1,000	1,000	500	
2	Add the amounts in columns (d) and (f)			1,000		500	
3	Tentative Hope credit. Add the amounts on line 2, columns (d) and (f). If you are claiming the lifetime learning credit, go to Part II; otherwise, go to Part III					3	1,500

Part II Lifetime Learning Credit

4	(a) Student's name (as shown on page 1 of your tax return) First name Last name	(b) Student's social security number (as shown on page 1 of your tax return)	(c) Qualified expenses. See instructions
	Sean Jones	246 : 00 : 9731	2,200
5	Add the amounts on line 4, column (c), and enter the total		2,200
6	Enter the smaller of line 5 or \$5,000.		2,200
7	Tentative lifetime learning credit. Multiply line 6 by 20% (.20) and go to Part III		440

Caution: You cannot take the Hope credit and the lifetime learning credit for the same student.

Part III Allowable Education Credits

8	Tentative education credits. Add lines 3 and 7		8	1,940
9	Enter: \$102,000 if married filing jointly; \$51,000 if single, head of household, or qualifying widow(er)		9	102,000
10	Enter the amount from Form 1040, line 36, or Form 1040A, line 22		10	84,000
11	Subtract line 10 from line 9. If line 10 is equal to or more than line 9, stop ; you cannot take any education credits		11	18,000
12	Enter: \$20,000 if married filing jointly; \$10,000 if single, head of household, or qualifying widow(er)		12	20,000
13	If line 11 is equal to or more than line 12, enter the amount from line 8 on line 14 and go to line 15. If line 11 is less than line 12, divide line 11 by line 12. Enter the result as a decimal (rounded to at least three places)		13	× .900
14	Multiply line 8 by line 13		14	1,746
15	Enter the amount from Form 1040, line 44, or Form 1040A, line 28		15	10,625
16	Enter the total, if any, of your credits from Form 1040, lines 45 through 47, or Form 1040A, lines 29 and 30		16	0
17	Subtract line 16 from line 15. If line 16 is equal to or more than line 15, stop ; you cannot take any education credits		17	10,625
18	Education credits. Enter the smaller of line 14 or line 17 here and on Form 1040, line 48, or Form 1040A, line 31		18	1,746

*See Pub. 970 for the amount to enter if you are filing Form 2555, 2555-EZ, or 4563 or you are excluding income from Puerto Rico.

For Paperwork Reduction Act Notice, see page 3.

Cat. No. 25379M

Form **8863** (2002)

Appendix B — Highlights of Tax Benefits for Education for Tax Year 2002

*This chart highlights some differences among the benefits discussed in this publication. See the text for definitions and details. Do not rely on this chart alone.
Caution: You generally cannot claim more than one benefit for the same education expense.*

	Hope Credit	Lifetime Learning Credit	Student Loan Interest Deduction	Tuition and Fees Deduction	Coverdell ESA ¹	Qualified Tuition Program (QTP) ¹	Early IRA Withdrawals ¹	Education Savings Bond Program ¹	Employer-Provided Educational Assistance ¹
What is your benefit?	Credits can reduce amount of tax you must pay	Can deduct interest paid	Can deduct interest	Can deduct expenses	Earnings not taxed	Earnings not taxed ²	No 10% additional tax on early withdrawal	Interest not taxed	Employer benefits not taxed
What is the annual limit?	\$1,500 credit per student	\$1,000 credit per family	\$2,500 deduction	\$3,000 deduction	\$2,000 contribution per beneficiary	None	Amount of qualifying expenses	Amount of qualifying expenses	\$5,250 exclusion
What expenses qualify besides tuition and enrollment fees?	None	Books Supplies Equipment Room & board Transportation Other necessary expenses	None	None	Books Supplies Equipment Expenses for special needs services Payments to QTP Higher education: Room & board if at least half-time student Elem/sec (K-12) education: Tutoring Room & board Uniforms Transportation Computer access Supplementary expenses	Books Supplies Equipment Room & board if at least half-time student Expenses for special needs services	Books Supplies Equipment Room & board if at least half-time student Expenses for special needs services	Payments to Coverdell ESA Payments to QTP	Books Supplies Equipment
What education qualifies?	1st 2 years of undergraduate (postsecondary)	Undergraduate & graduate Courses to acquire or improve job skills	Undergraduate & graduate	Undergraduate & graduate	Undergraduate & graduate K-12	Undergraduate & graduate	Undergraduate & graduate	Undergraduate & graduate	Undergraduate & graduate
What are some of the other conditions that apply?	Can be claimed for only 2 tax years Must be enrolled at least half-time in degree program No felony drug conviction(s)	Must have been at least half-time student in degree program	Cannot claim both deduction & education credit for same student in same year	Must withdraw assets at age 30 unless special needs beneficiary	Must withdraw assets at age 30 unless special needs beneficiary	Applies only to qualified series EE bonds issued after 1989 or series I bonds			
In what income range do benefits phase out?	\$41,000 – \$51,000 \$82,000 – \$102,000 for joint returns	\$50,000 – \$65,000 \$100,000 – \$130,000 for joint returns	No deduction if income is more than \$65,000 (\$130,000 for joint returns)	\$95,000 – \$110,000 \$190,000 – \$220,000 for joint returns	No phaseout	No phaseout	No phaseout	\$57,600 – \$72,600 \$86,400 – \$116,400 for joint returns	No phaseout

¹ Any nontaxable withdrawal is limited to the amount that does not exceed qualifying educational expenses.

² Does not apply to distributions from QTPs sponsored by educational institution until 1/1/04; however, no 10% additional tax is imposed.



529 plan (See Qualified tuition program (QTP))

A

Academic period (See name of benefit)
 Additional tax (See name of benefit)
 Assistance (See Tax help)

B

Bonds, education savings (See Education savings bond program)

C

Cancellation of student loan . . . 22-23
 Comments on publication 4
 Contributions (See name of benefit)
 Coverdell education savings account (See Coverdell ESA)
 Coverdell ESA:
 Additional tax:
 Distributions 36
 Excess contributions 33
 Withdrawals 36
 Contributions 31-33
 Designated beneficiary 30
 Distributions, taxability of . . . 34-39
 Eligible educational institution:
 Elementary/secondary 30
 Higher education 31
 Expenses, qualified 30-31
 Family members, defined 34
 Income limits 32-33
 Modified adjusted gross income (MAGI) 31-32
 Phaseout of contribution limit 32-33
 Qualified expenses:
 Elementary/secondary . . . 30-31
 Higher education 31
 Rollovers 33-34
 Taxability of 35-36
 Transfers 33-34
 What is an ESA 30
 Withdrawals, taxability of . . . 34-39

Credit (See Hope credit; Lifetime learning credit)

D

Dependent's expenses, claiming:
 Hope credit 9
 Lifetime learning credit 14-15
 Tuition and fees deduction 26-27
 Distributions (See name of benefit)

E

Education credit (See Hope credit; Lifetime learning credit)
 Education IRA (See Coverdell ESA)
 Education savings account (See Coverdell ESA)
 Education savings bond program:
 Form 8815, illustrated 49
 How to claim exclusion 48
 How to figure exclusion 47
 Illustrated example 47, 49
 Income limits 47
 Modified adjusted gross income (MAGI) 47
 Phaseout of exclusion 47
 Qualified expenses 46
 Who qualifies for exclusion . . . 46
 Educational assistance, employer-provided 50
 Educational institution (See Eligible educational institution)
 Eligible educational institution:
 Coverdell ESA:
 Elementary/secondary 30
 Higher education 31
 Hope credit 6
 IRA withdrawals, early 44
 Lifetime learning credit 13
 Qualified tuition program (QTP) 41
 Student loan interest deduction 20
 Tuition and fees deduction 25
 Eligible student:
 Hope credit 7-8
 Lifetime learning credit 14
 Student loan interest deduction 21
 Tuition and fees deduction 26
 Employer-provided educational assistance 50
 Excise tax (See *Additional tax* under name of benefit)
 Expenses (See Qualified expenses)

F

Form:
 1098-T 10, 15, 28
 1099-Q 41
 8815 47
 8815, illustrated 49
 8863 10, 15
 8863, illustrated 11, 17
 W-9S 10, 16, 28
 Free tax services 51

H

Help (See Tax help)
 Hope credit:
 Academic period 6
 Eligible educational institution . . . 6
 Eligible student 7-8
 Expenses, qualified 6-7
 Form 8863, illustrated 11, 54
 How to claim credit 10
 How to figure credit 9-10
 Illustrated example 10-11
 Income limits 9-10
 Modified adjusted gross income (MAGI) 9-10
 Phaseout of credit 9-10
 Qualified expenses 6-7
 Recapture 10
 Refund of expenses 7
 Tax benefit of 5
 Who can claim credit 6
 Who cannot claim credit 6

I

Important changes:
 Coverdell education savings account (ESA) 2, 3, 29
 Education savings bond program 3, 46
 Employer-provided educational assistance . . . 3, 50
 Hope credit 2, 5
 IRA withdrawals, early 3, 44
 Lifetime learning credit 2, 3, 12
 Qualified tuition program (QTP) 2-3, 40
 Student loan interest deduction 2, 3, 18
 Tuition and fees deduction 2
 Interest deduction (See Student loan interest deduction)
 Interest exclusion (See Education savings bond program)
 IRA withdrawals, early:
 Amount not subject to additional tax 44-45
 Eligible educational institution 44
 Qualified expenses 44
 IRA, education (See Coverdell ESA)

L

Lifetime learning credit:
 Academic period 13
 Eligible educational institution 13
 Eligible student 14

Expenses, qualified	13-14
Form 8863, illustrated	17, 54
How to claim credit	15
How to figure credit	15
Illustrated example	16-17
Income limits	15
Modified adjusted gross income (MAGI)	15
Phaseout of credit	15
Qualified expenses	13-14
Recapture	16
Refund of expenses	14
Tax benefit of	12
Who can claim credit	13
Who cannot claim credit	12-13
Loans, student:	
Cancellation of	22-23
Interest deduction	18-22

M

Modified adjusted gross income (MAGI):	
Coverdell ESA	31-32
Education savings bond program	47
Hope credit	9-10
Lifetime learning credit	15
Student loan interest deduction	22
Tuition and fees deduction	27
More information (See Tax help)	

P

Penalty (See <i>Additional tax</i> under name of benefit)	
Publications (See Tax help)	

Q

Qualified expenses:	
Coverdell ESA:	
Elementary/secondary	30-31
Higher education	31
Education savings bond program	46
Hope credit	6-7
IRA withdrawals, early	44
Lifetime learning credit	13-14
Qualified tuition program (QTP)	41
Student loan interest deduction	20
Tuition and fees deduction	24-26
Qualified state tuition program (See Qualified tuition program (QTP))	
Qualified tuition program (QTP):	
Additional tax	42-43

Beneficiary:	
Change of	43
Designated	41
Contributions	41
Designated beneficiary	41
Distributions, taxability of	41-43
Eligible educational institution	41
Family members, defined	43
Loss on investment	43
Qualified expenses	41
Rollovers	43
Taxability of	41-43
Transfers	43
What is a QTP	41
Withdrawals, taxability of	41-43

R

Recapture (See name of credit)	
Refund of expenses (See name of benefit)	
Rollovers (See name of benefit)	

S

Savings bond program, education (See Education savings bond program)	
Section 529 plan (See Qualified tuition program (QTP))	
Student loan interest deduction:	
Academic period	21
Eligible educational institution	20
Eligible student	21
Expenses, qualified	20
How much to deduct	21-22
How to claim deduction	22
Income limits	21-22
Modified adjusted gross income (MAGI)	22
Phaseout of deduction	21-22
Qualified expenses	20
Qualified interest	18-20
Tax benefit of	18
What interest qualifies	18-20
Who can claim deduction	20-21
Student loans:	
Cancellation of	22-23
Interest deduction	18-22
Suggestions for publication	4

T

Tables:	
Changes in Allowable Deduction Period for Student Loan Interest	19

Comparison of Education Credits	5, 13
Coverdell ESA At a Glance	30
Coverdell ESA Contributions At a Glance	32
Coverdell ESA Withdrawals At a Glance	34
Effect of MAGI on Student Loan Interest Deduction	21
Student Loan Interest Deduction At a Glance	18
Tuition and Fees Deduction At a Glance	24
Tax help	51
Taxpayer Advocate	51
Transfers (See name of benefit)	
TTY/TDD information	51
Tuition and fees deduction:	
Academic period	25
Eligible educational institution	25
Eligible student	26
Expenses, qualified	24-26
How to claim deduction	28
How to figure deduction	27
Income limits	27
Modified adjusted gross income (MAGI)	27
Qualified expenses	24-26
Refund of expenses	26
Tax benefit of	24
Who can take deduction	24
Who cannot take deduction	24
Tuition program, qualified state (See Qualified tuition program (QTP))	

W

Withdrawals (See name of benefit)	
Worksheets:	
Coverdell ESA — Taxable Withdrawals and Basis	38-39
Coverdell ESA Contribution Limit	33
MAGI for a Coverdell ESA	32
MAGI for the Hope Credit	10
MAGI for the Lifetime Learning Credit	15
MAGI for the Tuition and Fees Deduction	27
Student Loan Interest Deduction Worksheet	23

General Guides

- 1 Your Rights as a Taxpayer
- 17 Your Federal Income Tax (For Individuals)
- 334 Tax Guide for Small Business (For Individuals Who Use Schedule C or C-EZ)
- 509 Tax Calendars for 2003
- 553 Highlights of 2002 Tax Changes
- 910 Guide to Free Tax Services

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- 54 Tax Guide for U.S. Citizens and Residents Aliens Abroad
- 225 Farmer's Tax Guide
- 378 Fuel Tax Credits and Refunds
- 463 Travel, Entertainment, Gift, and Car Expenses
- 501 Exemptions, Standard Deduction, and Filing Information
- 502 Medical and Dental Expenses
- 503 Child and Dependent Care Expenses
- 504 Divorced or Separated Individuals
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- 551 Basis of Assets
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- 556 Examination of Returns, Appeal Rights, and Claims for Refund
- 559 Survivors, Executors, and Administrators
- 561 Determining the Value of Donated Property
- 564 Mutual Fund Distributions
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- 575 Pension and Annuity Income
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- 594 The IRS Collection Process
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- 908 Bankruptcy Tax Guide
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- 968 Tax Benefits for Adoption
- 969 Medical Savings Accounts (MSAs)
- 970 Tax Benefits for Education
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- 972 Child Tax Credit (For Individuals Sent Here From the Form 1040 or 1040A Instructions)
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- 579SP Cómo Preparar la Declaración de Impuesto Federal
- 594SP Comprendiendo el Proceso de Cobro
- 596SP Crédito por Ingreso del Trabajo
- 850 English-Spanish Glossary of Words and Phrases Used in Publications Issued by the Internal Revenue Service
- 1544SP Informe de Pagos en Efectivo en Exceso de \$10,000 (Recibidos en una Ocupación o Negocio)

Commonly Used Tax Forms

See *How To Get Tax Help* for a variety of ways to get forms, including by computer, fax, phone, and mail. For fax orders only, use the catalog number when ordering.

Form Number and Title	Catalog Number	Form Number and Title	Catalog Number
1040 U.S. Individual Income Tax Return	11320	2106 Employee Business Expenses	11700
Sch A&B Itemized Deductions & Interest and Ordinary Dividends	11330	2106-EZ Unreimbursed Employee Business Expenses	20604
Sch C Profit or Loss From Business	11334	2210 Underpayment of Estimated Tax by Individuals, Estates, and Trusts	11744
Sch C-EZ Net Profit From Business	14374	2441 Child and Dependent Care Expenses	11862
Sch D Capital Gains and Losses	11338	2848 Power of Attorney and Declaration of Representative	11980
Sch D-1 Continuation Sheet for Schedule D	10424	3903 Moving Expenses	12490
Sch E Supplemental Income and Loss	11344	4562 Depreciation and Amortization	12906
Sch EIC Earned Income Credit	13339	4868 Application for Automatic Extension of Time To File U.S. Individual Income Tax Return	13141
Sch F Profit or Loss From Farming	11346	4952 Investment Interest Expense Deduction	13177
Sch H Household Employment Taxes	12187	5329 Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts	13329
Sch J Farm Income Averaging	25513	6251 Alternative Minimum Tax—Individuals	13600
Sch R Credit for the Elderly or the Disabled	11359	8283 Noncash Charitable Contributions	62299
Sch SE Self-Employment Tax	11358	8582 Passive Activity Loss Limitations	63704
1040A U.S. Individual Income Tax Return	11327	8606 Nondeductible IRAs	63966
Sch 1 Interest and Ordinary Dividends for Form 1040A Filers	12075	8812 Additional Child Tax Credit	10644
Sch 2 Child and Dependent Care Expenses for Form 1040A Filers	10749	8822 Change of Address	12081
Sch 3 Credit for the Elderly or the Disabled for Form 1040A Filers	12064	8829 Expenses for Business Use of Your Home	12332
1040EZ Income Tax Return for Single and Joint Filers With No Dependents	11329	8863 Education Credits	25379
1040-ES Estimated Tax for Individuals	11340	9465 Installment Agreement Request	14842
1040X Amended U.S. Individual Income Tax Return	11360		