Department of the Treasury
Internal Revenue Service

Publication 970
Cat. No. 25221V

Tax Benefits for Higher Education

For use in preparing

2001 Returns

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Contents

Important Change for 2001

Name change. Effective July 26, 2001, ***all*** education individual retirement accounts (education IRAs) have been renamed Coverdell education savings accounts (Coverdell ESAs).

Important Changes for 2002

Deduction for higher education expenses. Beginning in 2002, in addition to education benefits available in 2001, you may also 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 Publication 553, *Highlights of 2001 Tax Changes*.

Student loan interest deduction. Beginning in 2002, you will be allowed to deduct student loan interest you pay even after the end of the 60-month period that began when you were first required to make a payment. Also, the income level at which your deduction will be reduced or eliminated will be increased. For more information about the student loan interest deduction, see chapter 3 in this publication. For more information about the 2002 changes, see Publication 553.

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.
- The final date on which you can make contributions to a Coverdell ESA for any year has been extended to the due date of your return for that year (not including extensions).
- Qualified education expenses will include certain elementary and secondary education expenses.
- You can make contributions to a Coverdell ESA for a special needs beneficiary after his or her 18th birthday.
- 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 Coverdell ESA is not used for the same expenses for which a credit is claimed.
- You can make contributions to a Coverdell ESA and a qualified tuition program in the same year for the same beneficiary.

For more information about Coverdell ESAs, see chapter 4 in this publication. For more information about 2002 changes, see Publication 553.

Employer-provided educational assistance. The tax-free status of up to $5,250 of employer-provided educational assistance benefits each year for undergraduate-level courses was scheduled to end for courses beginning after December 31, 2001. This benefit has been extended and, beginning in 2002, it also applies to graduate-level courses. For more information, see chapter 7 in this publication.

Qualified tuition programs (QTPs). 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 higher education.
- You can make contributions to a QTP established and maintained by one or more eligible educational institutions, but earnings on the account will be taxable if withdrawn before January 1, 2004.
- Amounts in a QTP can be rolled over, tax free, to another QTP set up for the same beneficiary. However, the 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.
- For purposes of rollovers and changes of designated beneficiaries, the definition of family members is expanded to include first cousins of the beneficiary.
- Calculation of the amount that is considered reasonable for room and board expenses has been changed. You must contact the educational institution for their 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 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 from the QTP is not used for the same expenses for which the credit is claimed.
- You can make contributions to a Coverdell ESA and a qualified tuition program in the same year for the same beneficiary.

For more information about qualified tuition programs, see chapter 8 in this publication. For more information about 2002 changes, see Publication 553.

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.

Seven other types of benefits are explained in chapters 3 through 8. With these benefits, you may be able to:

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

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 42 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 tax benefits for higher education 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, *Tax Benefits for Work-Related Education*.
Scholarships that you may be able to exclude from income	Publication 520, *Scholarships and Fellowships*.

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**.

You can write to us at the following address:

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Washington, DC 20224

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 2001 Tax Changes

Form (and Instructions)

- ❏ **8815** Exclusion of Interest From Series EE and I U.S. Savings Bonds Issued After 1989
- ❏ **8863** Education Credits (Hope and Lifetime Learning Credits)
- ❏ **8606** Nondeductible IRAs and Coverdell ESAs

See *How To Get Tax Help* in chapter 9 for information about getting these publications and forms.

1. Hope Credit

Important Change 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). You cannot use expenses paid with a distribution from either a Coverdell ESA or a QTP as the basis for the Hope credit. For more information about changes to the rules for Coverdell ESAs and new rules for QTPs, see Publication 553.

Introduction

The Hope credit may be available to you if you pay higher education costs.

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

The lifetime learning credit is discussed in chapter 2.

This chapter explains:

- Who can claim the Hope credit,
- What expenses qualify for the credit,
- 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.

Credit more than tax. Your Hope credit cannot be more than the amount of your tax. Therefore, you cannot get a refund for any part of the credit that is more than 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 2001 tax return, you cannot, for that same child, also claim the lifetime learning credit for 2001.

Lifetime learning credit after Hope credit. You can claim the Hope credit for the first 2 years of an eligible student's postsecondary education and claim the lifetime learning credit for that same student in later years.

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. **Comparison of Education Credits**

Hope Scholarship Credit	Lifetime Learning Credit
Up to $1,500 credit per **eligible student**	Up to $1,000 credit per **return**
Available **ONLY** for the first two years of postsecondary education	Available for all years of postsecondary education
Available **ONLY** for 2 years per eligible student	Available for an unlimited number of years
Student must be pursuing a degree or other recognized educational 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 separate return.
- 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 $50,000 or more ($100,000 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 2001 and the nonresident alien did not elect to be treated as a resident alien. More information on nonresident aliens can be found in Publication 519, *U.S. Tax Guide for Aliens*.
- The eligible student received a tax-free withdrawal from a Coverdell ESA during 2001 and did not waive the tax-free treatment. This waiver is discussed in chapter 4 under *Waiver of Tax-Free Treatment*.
- You claim the lifetime learning credit for the same student in 2001.

Who Can Claim the Credit?

Generally, you can claim the Hope credit if you pay ***qualified tuition and related expenses*** of higher education for an ***eligible student*** who 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 later under *What Expenses Qualify?* Eligible students are defined later under *Who Is an Eligible Student?*

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

Who Can Claim A Dependent's Expenses?

If there are 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.

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	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.

TIP *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 2001 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 Ms. Allen 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 else, such as his parents, claims an exemption for him on their tax return, whoever claims the exemption may be able to use the expenses to claim a Hope credit. In this case, Todd cannot claim a Hope credit.

Who Is an Eligible Student?

For purposes of the Hope credit, an eligible student 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 years.
2) Had not ***completed the first 2 years*** of postsecondary education (generally, the freshman and sophomore years of college) before 2001.
3) Was ***enrolled at least half-time*** in a program that leads to a degree, certificate, or other recognized educational credential for at least one ***academic period*** beginning in 2001.
4) Was free of any federal or state felony conviction for possessing or distributing a controlled substance as of the end of 2001.

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 2001 has completed the first 2 years of postsecondary education. This student would not be an eligible student for purposes of the Hope credit.

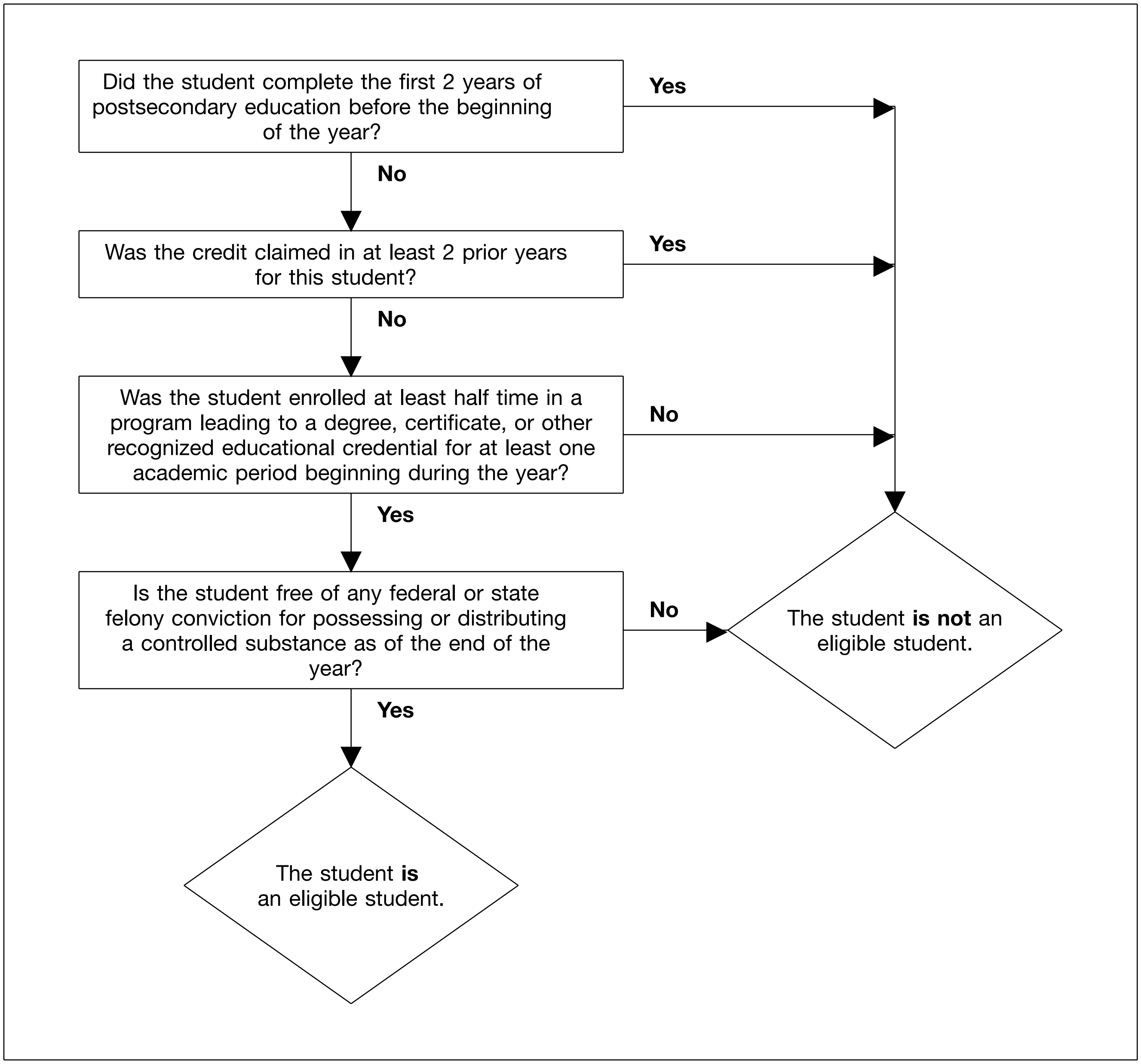
Any academic credit awarded solely on the basis of the student's performance on proficiency examinations is disregarded in determining whether the student has completed 2 years of postsecondary education.

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.

Figure 1–1. **Who Is an Eligible Student?**

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



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.

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 2001 for an ***academic period*** (defined earlier) beginning in 2001 or in the first 3 months of 2002. See *Prepaid expenses*, later.

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***.

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.

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.

Prepaid expenses. If you paid qualified tuition and related expenses in 2001 for an academic period that begins in the first three months of 2002, you can use the prepaid amount in figuring your 2001 Hope credit.

For example, if you paid $1,500 in December 2001 for qualified tuition for the winter 2002 semester beginning in January 2002, you can use that $1,500 in figuring your 2001 credit.

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.

Adjustments To Qualified Expenses

If you pay 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.

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.

No double benefit allowed. You cannot:

- Deduct higher education expenses on your income tax return 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 education expenses, or
- Claim a credit based on expenses paid with tax-free scholarship, grant, or employer-provided educational assistance. See *Adjustments to Qualified Expenses*, earlier.

Refunds. Qualified tuition and related expenses do not include expenses for which you receive a refund. If you paid expenses in 2001, and you received a refund of those expenses before you file your tax return for 2001, simply reduce the amount of the expenses paid by the amount of the refund received. If you receive the refund after you file your 2001 tax return, see *When Must the Credit Be Repaid*, later.

How Is the Credit Figured?

The amount of the Hope credit is the sum of:

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

The maximum amount of Hope credit you can claim in 2001 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. See *Does the Amount of Your Income Affect the Amount of Your Credit*, later.

Example 1. Jon and Karen are married and file a joint tax return. For 2001, they claim an exemption for their dependent daughter on their tax return. Their modified adjusted gross income is $70,000. Their daughter is in her sophomore (second) year of studies at the local university. Jon and Karen pay qualified tuition and related expenses of $4,300 in 2001.

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 2001. 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 modified adjusted gross income is between $40,000 and $50,000 ($80,000 and $100,000 if you file a joint return). You cannot claim a Hope credit if your modified adjusted gross income is $50,000 or more ($100,000 or more if you file a joint return).

The phaseout, if any, can be figured in Part III of Form 8863 or as shown in *Example 2*.

Example 2. The information is the same as in *Example 1* except that Jon and Karen have a modified adjusted gross income 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 *Example 1* above, 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 they are filing a joint return, the numerator of the fraction is $100,000 minus their modified adjusted gross income and the denominator is $20,000. The result is the amount of their Hope credit.

$$\$1{,}500 \times \frac{\$100{,}000 - \$88{,}000}{\$20{,}000} = \$900$$

Modified adjusted gross income. For most taxpayers, modified adjusted gross income (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 19 of that form.

MAGI when using Form 1040. If you file Form 1040, your MAGI is the AGI on line 33 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.

Worksheet 1–1, can be used to figure your MAGI.

How Is the Credit Claimed?

You elect to claim the Hope credit and you figure the amount to claim by completing Parts I and III of **Form 8863**. 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 2001 generally must issue **Form 1098–T**, *Tuition Payments Statement,* to each student by February 1, 2002. The information on Form 1098–T will help you determine whether you can claim an education tax credit for 2001. 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.

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

1. Enter your adjusted gross income (Form 1040, line 33)		1. $
2. Enter your foreign earned income exclusion (Form 2555, line 40, or Form 2555–EZ, line 18)	2. $	
3. Enter your housing exclusion (Form 2555, line 34).	3.	
4. Enter the amount of income from Puerto Rico that you are excluding. . .	4.	
5. Enter the amount of income from American Samoa that you are excluding (Form 4563, line 15).	5.	
6. Add the amounts on lines 2, 3, 4, and 5.		6.
7. Add the amounts on lines 1 and 6. This is your **modified adjusted gross income**. Enter this amount on line 10 of your Form 8863.		7. $

When Must the Credit Be Repaid?

If, after you file your 2001 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 2001 as if the assistance or refund was received in 2001. Subtract the amount of the refigured credit from the amount of the credit you claimed. The result is the amount you must repay. See the instructions for your 2002 tax return for information about how and where to report the repayment (recapture).

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 2001, he paid $1,600 for his qualified 2001 tuition. He and the college meet all of the requirements for the Hope credit. Jim's modified adjusted gross income is $32,000. His income tax liability is $3,746. 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 the Hope credit and the lifetime learning credit are both claimed on the same tax return.

Form **8863**

Department of the Treasury
Internal Revenue Service

Education Credits
(Hope and Lifetime Learning Credits)

► See instructions on pages 2 and 3. ► Attach to Form 1040 or Form 1040A.

OMB No. 1545-1618

2001

Attachment Sequence No. **50**

Name(s) shown on return	Your social security number
Jim Grant	000 00 1111

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, Last	**(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 1111	1,600	1,000	600	300
2	Add the amounts in columns (d) and (f)		2	1,000		300
3	Tentative Hope credit. Add the amounts on line 2, columns (d) and (f) . . . . ►				3	1,300

Part II **Lifetime Learning Credit**

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

4	**(a)** Student's name (as shown on page 1 of your tax return) First	Last	**(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) . . . . ►	7	

Part III **Allowable Education Credits**

8	Tentative education credits. Add lines 3 and 7.			8	1,300
9	Enter: $100,000 if married filing jointly; $50,000 if single, head of household, or qualifying widow(er)	9	50,000		
10	Enter the amount from Form 1040, line 34 (or Form 1040A, line 20)*	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	18,000		
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 42 (or Form 1040A, line 26)			15	3,746
16	Enter the total, if any, of your credits from Form 1040, lines 43 through 45 (or from Form 1040A, lines 27 and 28).			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	3,746
18	**Education credits.** Enter the **smaller** of line 14 or line 17 here and on Form 1040, line 46 (or Form 1040A, line 29) . . . . ►			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.

For Paperwork Reduction Act Notice, see page 4. Cat. No. 25379M Form **8863** (2001)

2.

Lifetime Learning Credit

Important Change 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). You cannot use expenses paid with a distribution from either a Coverdell ESA or a QTP as the basis for the lifetime learning credit. For more information about changes to the rules for Coverdell ESAs and new rules for QTPs, see Publication 553.

Introduction

The lifetime learning credit may be available to you if you pay higher education costs.

Table 2–1 summarizes the differences between the lifetime learning and Hope credits. If you are eligible to claim both credits based on the higher education expenses of one student, it will generally be to your benefit to claim the Hope credit.

The Hope credit is discussed in chapter 1.

This chapter explains:

- Who can claim the lifetime learning credit,
- What expenses qualify for the credit,
- 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 for which 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.

Credit more than tax. Your lifetime learning credit cannot be more than the amount of your tax. Therefore, you cannot get a refund for any part of the credit that is more than 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 2001 tax return, you cannot, for that same child, also claim the Hope credit for 2001.

Lifetime learning credit after Hope credit. You can claim the Hope credit for the first 2 years of an eligible student's postsecondary education and claim the lifetime learning credit for that same student in later years.

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. **Comparison of Education Credits**

Lifetime Learning Credit	Hope Scholarship Credit
Up to $1,000 credit per **return**	Up to $1,500 credit per **eligible student**
Available for all years of postsecondary education	Available **ONLY** for the first two years of postsecondary education
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 a 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

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 separate return.
- 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 $50,000 or more ($100,000 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 2001 and the nonresident alien did not elect to be treated as a resident alien. More information on nonresident aliens can be found in Publication 519, *U.S. Tax Guide for Aliens*.
- The eligible student received a tax-free withdrawal from a Coverdell ESA during 2001 and did not waive the tax-free treatment. This waiver is discussed in chapter 4 under *Waiver of Tax-Free Treatment*.
- You claim the Hope credit for the same student in 2001.

Who Can Claim the Credit?

Generally, you can claim the lifetime learning credit if you pay ***qualified tuition and related expenses*** of higher education for an ***eligible student*** who 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 later under *What Expenses Qualify?* Eligible students are defined later under *Who Is an Eligible Student?*

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

Who Can Claim a Dependent's Expenses?

If there are 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.

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	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.

TIP *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 2001 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 Ms. Allen 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 else, such as his parents, claims an exemption for him on their tax return, whoever claims the exemption may be able to use the expenses to claim a lifetime learning credit. In this case, Todd cannot claim a lifetime learning credit.

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***.

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.

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 2001 for an ***academic period*** beginning in 2001 or in the first 3 months of 2002. See *Prepaid expenses*, later.

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*** (defined earlier).

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.

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.

Prepaid expenses. If you paid qualified tuition and related expenses in 2001 for an academic period that begins in the first three months of 2002, you can use the prepaid amount in figuring your 2001 lifetime learning credit.

For example, if you paid $1,500 in December 2001 for qualified tuition for the winter 2002 semester beginning in January 2002, you can use that $1,500 in figuring your 2001 credit.

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.

Adjustments to Qualified Expenses

If you pay 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.

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, in the case of the lifetime learning credit, is taken by the student to acquire or improve job skills, these expenses can qualify.

No double benefit allowed. You cannot:

- Deduct higher education expenses on your income tax return 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 education expenses, or
- Claim a credit based on expenses paid with tax-free scholarship, grant, or employer-provided educational assistance. See *Adjustments to Qualified Expenses*, earlier.

Refunds. Qualified tuition and related expenses do not include expenses for which you receive a refund. If you paid expenses in 2001, and you received a refund of those expenses before you file your tax return for 2001, simply reduce the amount of the expenses paid by the amount of the refund received. If you receive the refund after you file your 2001 tax return, see *When Must the Credit Be Repaid*, later.

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 2001 is $1,000 (20% × $5,000). However, that amount may be reduced based on your modified adjusted gross income. See *Does the Amount of Your Income Affect the Amount of Your Credit*, later.

Example 1. Bruce and Toni are married and file a joint tax return. For 2001, their modified adjusted gross income 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 2001, Toni paid $4,000 for her fall 2001 semester. Bruce and Toni can claim an $800 (20% × $4,000) lifetime learning credit on their 2001 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 modified adjusted gross income is between $40,000 and $50,000 ($80,000 and $100,000 if you file a joint return). You cannot claim a lifetime learning credit if your modified gross income is $50,000 or more ($100,000 or more if you file a joint return).

The phaseout, if any, can be figured in Part III of Form 8863 or as shown in *Example 2*.

Example 2. The information is the same as in *Example 1* above, except that Bruce and Toni have a modified adjusted gross income 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 above, the result is an $800 (20% x $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 $100,000 minus their modified adjusted gross income and the denominator is $20,000. The result is the amount of their lifetime learning credit.

$$\$800 \times \frac{\$100{,}000 - \$88{,}000}{\$20{,}000} = \$480$$

Modified adjusted gross income. For most taxpayers, modified adjusted gross income (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 19 of that form.

MAGI when using Form 1040. If you file Form 1040, your MAGI is the AGI on line 33 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.

Worksheet 2–1, can be used to figure your MAGI.

How Is the Credit Claimed?

You elect to claim the lifetime learning credit and you figure the amount to claim by completing Parts II and III of **Form 8863**. 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 2001 generally must issue **Form 1098–T**, *Tuition Payments Statement,* to each student by February 1, 2002. The information on Form 1098–T will help you determine whether you can claim an education tax credit for 2001. 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?

If, after you file your 2001 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 2001 as if the assistance or refund was received in 2001. Subtract the amount of the refigured credit from the amount of the credit you claimed. The result is the amount you must repay. See the instructions for your 2002 tax return for information about how and where to report the repayment (recapture).

Worksheet 2–1. **MAGI for the Lifetime Learning Credit**

1. Enter your adjusted gross income (Form 1040, line 33)		1. $
2. Enter your foreign earned income exclusion (Form 2555, line 40, or Form 2555–EZ, line 18).	2. $	
3. Enter your housing exclusion (Form 2555, line 34).	3.	
4. Enter the amount of income from Puerto Rico that you are excluding. . .	4.	
5. Enter the amount of income from American Samoa that you are excluding (Form 4563, line 15).	5.	
6. Add the amounts on lines 2, 3, 4, and 5.		6.
7. Add the amounts on lines 1 and 6. This is your **modified adjusted gross income**. Enter this amount on line 10 of your Form 8863.		7. $

Illustrated Example

Judy Green, a single taxpayer, is taking courses at a community college to be recertified to teach in public schools. Her modified adjusted gross income is $22,000. Her tax is $2,246. In July 2001 she pays $700 for the summer 2001 semester; in August 2001 she pays $1,900 for the fall 2001 semester; and in December 2001 she pays another $1,900 for the winter semester. 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 2001 when figuring her credit for her 2001 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 the Hope credit and the lifetime learning credit are both claimed on the same tax return.

Form **8863**

Department of the Treasury
Internal Revenue Service

Education Credits (Hope and Lifetime Learning Credits)

▶ See instructions on pages 2 and 3. ▶ Attach to Form 1040 or Form 1040A.

OMB No. 1545-1618

2001

Attachment Sequence No. **50**

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, Last	(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) . . . . ▶ **3**

Part II **Lifetime Learning Credit**

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

4	(a) Student's name (as shown on page 1 of your tax return) First	Last	(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) ▶	7	900

Part III **Allowable Education Credits**

8	Tentative education credits. Add lines 3 and 7			8	900
9	Enter: $100,000 if married filing jointly; $50,000 if single, head of household, or qualifying widow(er)	9	50,000		
10	Enter the amount from Form 1040, line 34 (or Form 1040A, line 20)*	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	28,000		
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 42 (or Form 1040A, line 26)			15	2,246
16	Enter the total, if any, of your credits from Form 1040, lines 43 through 45 (or from Form 1040A, lines 27 and 28)			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	2,246
18	**Education credits.** Enter the **smaller** of line 14 or line 17 here and on Form 1040, line 46 (or Form 1040A, line 29) ▶			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.

For Paperwork Reduction Act Notice, see page 4. Cat. No. 25379M Form **8863** (2001)

3. Student Loans

Important Changes for 2002

Beginning January 1, 2002, the requirement that you can only deduct interest paid during the first 60 months that interest payments are required is eliminated. Also, the income level at which your deduction will be reduced or eliminated will be increased. See Publication 553 for more information.

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 2001, you may be able to deduct up to $2,500 of the interest you paid. You can deduct interest paid during the ***first 60 months*** that interest payments are required on the loan.

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 2001.

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).

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 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) and capitalized interest are student loan interest if all other requirements are met.

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.

Do Not Include As Interest

You cannot claim a deduction for student loan interest if either of the following apply.

- The interest was paid on a ***loan from a related person***.
- The interest was paid on a ***loan from a qualified employer plan***.

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.

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 taken 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***.

6) The ***first 60 months*** in which interest payments were required on the loan did not end before January 2001.

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 on their tax return if they list your name on line 6c, 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).

However, you must reduce these costs by the ***total*** amount paid for them with the following tax-free items.

- Employer-provided educational assistance benefits. See chapter 7.
- Tax-free withdrawals from a Coverdell ESA (formerly known as an education IRA). However, the tax-free treatment of the withdrawal can be waived. See chapter 4.
- U.S. savings bond interest used to pay qualified higher education expenses. See chapter 6.
- 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.

TIP *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 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 post-secondary 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 that leads 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.

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	The student loan • must have been taken 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 • you, your spouse or your dependent • enrolled at least half-time in a degree program.
Time limit on deduction	The interest deduction can be taken only during the first 60 months of required interest payments.
Phaseout	The amount of the deduction depends on your income level.

What Is the 60-Month Period?

Regardless of when you took out a student loan, you can only deduct the interest paid during the first 60 months that interest payments are required on that loan.

No deduction is allowed for interest payments due or paid before 1998.

Example. You took out a student loan in 1994. You made a payment on the loan every month, as required, beginning October 1, 1996. You can deduct the interest on your first nine payments for 2001. You cannot deduct the interest on any later payments because they are after the 60-month period (October 1, 1996 – September 30, 2001).

TIP *Beginning in 2002, the requirement that you can only deduct interest paid during the first 60 months that interest payments are required is eliminated. See Publication 553 for more information.*

Beginning of 60-month period. The date the 60-month interest deduction period begins is based on:

- The terms of the loan agreement, or
- Applicable federal regulations, if the loan was issued or guaranteed under a Federal post-secondary education program.

CAUTION *The 60-month period continues to pass whether or not required interest payments are actually made. However, the 60 months may or may not be consecutive. For more information, see* Suspension of 60-month period*, later.*

Effect of refinancing. Generally, the refinancing of a student loan has no effect on the 60-month period. All refinancings of a student loan are the same loan for the purposes of determining the 60-month period. A refinanced loan has the same 60-month period as the original loan. See *Consolidated loan* and *Collapsed loans*, later.

Example. You obtained a qualified education loan to pay for an undergraduate degree at an eligible educational institution. After graduation, you were required to make monthly interest payments on the loan beginning in January 2000. You made the required interest payments through March 2001 (15 months).

In April 2001, you borrowed money from a different lender for no other reason than to pay off the first education loan. This new loan required you to start making interest payments immediately. Since this is a single loan used to pay off the original single loan, you have only forty-five months remaining of the original 60-month student loan interest deduction period.

Consolidated loan. This is a loan that refinances more than one student loan of the same borrower. The 60-month period for a consolidated loan begins on the most recent date on which interest payments became due on any of the refinanced loans.

Example. You obtained a qualified education loan to pay for an undergraduate degree at an eligible educational institution. After graduation, you were required to make monthly interest payments on the loan beginning in January 2000. You made the required interest payments through March 2001 (15 months).

You had also obtained a second qualified education loan to pay for a graduate degree at an eligible educational institution. After graduation, you were required to make monthly interest payments on the second loan beginning in January 2001. You made the required interest payments through March 2001 (3 months).

In April 2001, you borrowed money from a lender for no other reason than to combine both education loans into one loan payment. This new loan required you to start making interest payments immediately. You have fifty-seven months remaining of the original 60-month period because only three months had passed since the most recent date on which interest payments became due on either of the two loans (January 2001).

Collapsed loans. These are two or more loans of the same borrower that are treated by both the lender and the borrower as one loan. The 60-month period for a collapsed loan begins on the most recent date on which interest payments became due on any of the separate loans.

Example. To finance your education, you obtained four separate qualified education loans. The loans entered repayment status on the following dates.

- January 1, 2000.
- April 1, 2000.
- July 1, 2000.
- October 1, 2000.

In January 2001, your lender advised you that all four had been transferred to a different lender for loan servicing purposes.

The new lender treats the loans as a single loan and does not keep separate records for each loan. You are sent a single statement that shows the total principal and interest.

Your 60-month period for deducting interest on the collapsed loan is considered to have started on October 1, 2000, the most recent date that any of the four original loans entered repayment status.

Suspension of 60-month period. The 60-month period is suspended for any period of time during which interest payments are not required by the lender. However, the 60-month period is not suspended if, under the terms of the loan, both of the following statements are true.

1) Interest continues to accrue (be charged) during a period of deferment or forbearance.
2) You elect to make interest payments during this period, rather than have the interest capitalized.

Exception. If a student loan was not issued or guaranteed under a federal postsecondary education loan program, the 60-month period is suspended only if the borrower meets certain conditions. Those conditions include:

- Half-time study at a postsecondary educational institution,
- Study in an approved graduate fellowship program,
- Study in an approved rehabilitation program for the disabled,
- Inability to find full-time employment,
- Economic hardship, and
- The performance of services in certain occupations or federal programs.

However, the amount determined above may be gradually reduced (phased out) or eliminated based on your filing status and modified adjusted gross income 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 modified adjusted gross income is between $40,000 and $55,000 ($60,000 and $75,000 if you file a joint return). You cannot take a student loan interest deduction if your modified adjusted gross income is $55,000 or more ($75,000 or more if you file a joint return).

The following chart describes the affect the amount of your modified adjusted gross income has on the student loan interest deduction you are allowed to claim.

IF your filing status is. . .	AND your modified AGI is. . .	THEN your student loan interest deduction is. . .
Single, Head of household, or Qualifying widow(er)	Not more than $40,000	Not affected by the phaseout.
	More than $40,000 but less than $55,000	Reduced because of the phaseout.
	$55,000 or more	Eliminated by the phaseout.
Married filing joint return	Not more than $60,000	Not affected by the phaseout.
	More than $60,000 but less than $75,000	Reduced because of the phaseout.
	$75,000 or more	Eliminated by the phaseout.

How Much Can You Deduct?

Your student loan interest deduction for 2001 is generally the smaller of:

1) $2,500, or
2) Your interest payments that were both:
   a) Paid in 2001, and
   b) Paid during the first 60 months that interest payments were required.

How the phaseout works. To figure the phaseout, multiply your interest deduction (before the phaseout) by a fraction. The numerator is your modified adjusted gross income minus $40,000 ($60,000 in the case of a joint return). The denominator is $15,000. Subtract the result from your deduction (before the phaseout). This result is the amount you can deduct.

Example 1. During 2001 you paid $800 interest on a qualified student loan. Your 2001 modified adjusted gross income is $72,000 and you are filing a joint return. You must reduce your deduction by $640, figured as follows.

$$\$800 \times \frac{\$72{,}000 - \$60{,}000}{\$15{,}000} = \$640$$

You can deduct $160 ($800 – $640).

Example 2. The facts are the same as in *Example 1* except that you paid $2,750 interest. Your maximum deduction for 2001 is $2,500. You must reduce your maximum deduction by $2,000, figured as follows.

$$\$2{,}500 \times \frac{\$72{,}000 - \$60{,}000}{\$15{,}000} = \$2{,}000$$

You can deduct $500 ($2,500 – $2,000).

Modified adjusted gross income. For most taxpayers, modified adjusted gross income (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 19 of that form figured without taking into account any amount on line 17 (Student loan interest deduction).

MAGI when using Form 1040. If you file Form 1040, your MAGI is the AGI on line 33 of that form figured without taking into account any amount on line 24 (Student loan interest deduction), and modified by adding back any:

1) Foreign earned income exclusion,
2) Foreign housing exclusion or deduction,
3) Exclusion of income for bona fide residents of American Samoa, and
4) 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* in this publication.

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 24 of Form 1040, or line 17 of Form 1040A.

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 23 and lines 25 through 31a, before using this worksheet.*

1. Enter the total interest you paid in 2001 on qualified student loans. Do not include interest that was required to be paid after the first 60 months . . . . **1.** ______

2. Enter the **smaller** of line 1 or $2,500 . . . . **2.** ______

3. Enter your total income from Form 1040, line 22 . . . . **3.** ______

4. Enter any IRA deduction from Form 1040, line 23 . . . . **4.** ______

5. Enter the total of any amounts from Form 1040, lines 25 through 31a . . . . . . **5.** ______

6. Add the amounts on lines 4 and 5 . . . . **6.** ______

7. Subtract the amount on line 6 from the amount on line 3 . . . **7.** ______

8. Enter any foreign earned income exclusion (Form 2555, line 40, or Form 2555-EZ, line 18) . . . . **8.** ______

9. Enter any housing exclusion and/or deduction (Form 2555, lines 34 and 48) . . . . **9.** ______

10. Enter the amount of income from Puerto Rico that you are excluding . . . . **10.** ______

11. Enter the amount of income from American Samoa that you are excluding (Form 4563, line 15) . . . . **11.** ______

12. Add the amounts on lines 7 through 11. This is your modified adjusted gross income **12.** ______

13. Enter the amount shown below for your filing status . . . . **13.** ______

- Single, head of household, or qualifying widow(er)—$40,000
- Married filing jointly—$60,000

14. Is the amount on line 12 more than the amount on line 13?

☐ **No.** Skip line 15, enter -0- on line 16, and go to line 17.

☐ **Yes.** Subtract line 13 from line 12 . . . . **14.** ______

15. Divide line 14 by $15,000. Enter the result as a decimal (rounded to at least three places). Do not enter more than “1.000” . . . . **15.** ______

16. Multiply line 2 by line 15 . . . . **16.** ______

17. **Student loan interest deduction.** Subtract line 16 from line 2. Enter the result here and on Form 1040, line 24. **Do not** include this amount in figuring any other deduction on your return (such as on Schedule A, C, E, etc.) . . . . **17.** ______

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 canceled, 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***.

CAUTION *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.

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. Coverdell Education Savings Accounts (ESAs) — Formerly Education IRAs

Important Change for 2001

Name change. Education individual retirement accounts (IRAs) have been renamed Coverdell education savings accounts (Coverdell ESAs).

Important Changes for 2002

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

Income limitations. 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. For more information, see *Contributions* in this chapter.

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

Qualified expenses. Qualified education expenses have been expanded to include certain elementary and secondary education expenses. For more information, see Publication 553.

Special needs beneficiaries. You can continue to make contributions to a Coverdell ESA for a special needs beneficiary after his or her 18th birthday. For more information about contributions, see *Contributions* in this chapter.

You can leave assets in a Coverdell ESA set up for a special needs beneficiary after the beneficiary reaches age 30.

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

Coordination with qualified tuition programs (QTPs). You can make contributions to Coverdell ESAs and qualified tuition programs in the same year for the same beneficiary.

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.

- During ***2001***, you could contribute up to $500 cash to a Coverdell ESA for a beneficiary under age 18.
- For ***2002***, you can contribute up to $2,000 cash and, in some cases, 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 cannot be more than $500 for 2001 ($2,000 for 2002) 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 *Withdrawals,* later.

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.

Generally, when the account is established, the designated beneficiary must be under age 18.

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

Beginning in 2002, the designated beneficiary can be 18 or older if he or she is a special needs beneficiary.

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 (Beginning in 2002, this does not apply if the beneficiary is a special needs beneficiary).
   c) Would not result in total contributions for 2001 (not including rollover contributions) being more than $500 ($2,000 for 2002).
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. (Beginning in 2002, this rule no longer applies if the beneficiary is a special needs beneficiary).
   b) The beneficiary's death.

Table 4–1. **2001 Coverdell ESAs 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.
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 ($160,000 in the case of a joint return).

Qualified education expenses. These are expenses required for the enrollment or attendance of the designated beneficiary at an ***eligible educational institution***. The following items are qualified education expenses.

1) Tuition and fees.
2) The cost of books, supplies, and equipment.
3) Amounts contributed to a qualified state tuition program. (See chapter 8, *Qualified State Tuition Programs*.)
4) In some situations, the cost of room and board.

The cost of room and board is a qualified education expense if the designated beneficiary is at least a ***half-time student*** at an eligible educational institution.

The expense for room and board is limited to one of the following two amounts.

1) The school's posted room and board charge for students living on campus.
2) $2,500 each year for students living off campus and not at home.

Beginning in 2002, you can also use withdrawals from a Coverdell ESA account for certain elementary and secondary education expenses. For an explanation of elementary and secondary education expenses for which a withdrawal from a Coverdell ESA can be used, see Publication 553.

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.

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.

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*** for the year is less than $110,000. For individuals filing joint returns, that amount is $160,000 for 2001 and $220,000 for 2002.

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

Contributions must be in cash.

For 2001, contributions:

1) Cannot be made after the beneficiary reaches age 18, and
2) Must be made by December 31, 2001.

For 2002, contributions:

1) Can be made after the beneficiary reaches age 18 if the beneficiary is a special needs beneficiary, and
2) Must be made by the due date of the 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.

CAUTION *For 2001, no contributions can be made to a Coverdell ESA on behalf of a designated beneficiary if any amount is contributed during the year to a* **qualified state tuition program** *on behalf of the same beneficiary. Beginning in 2002, contributions can be made to a Coverdell ESA and a qualified tuition program in the same year for the same beneficiary without penalty.*

Modified adjusted gross income. For most taxpayers, modified adjusted gross income (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 19 of that form.

MAGI when using Form 1040. If you file Form 1040, your MAGI is the AGI on line 33 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.

Worksheet 4–1, can be used to figure your MAGI.

Contribution Limits

There are two yearly limits:

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

Limit for each designated beneficiary. The total of all contributions to all Coverdell ESAs set up for the benefit of any one designated beneficiary cannot be more than $500 in 2001 ($2,000 for 2002). This includes contributions (other than rollovers) to all the beneficiary's Coverdell ESAs from all sources. Rollovers are discussed under *Rollovers and Other Transfers*, later.

Limit for each contributor. You can contribute up to $500 for each designated beneficiary for 2001 ($2,000 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. However, this limit may be reduced as explained below.

In 2001, if your ***modified adjusted gross income*** (defined earlier) is between $95,000 and $110,000 (between $150,000 and $160,000 if filing a joint return), the $500 limit for each designated beneficiary is gradually reduced (see *Figuring the limit*, next). If your modified adjusted gross income is $110,000 or more ($160,000 or more if filing a joint return), you cannot contribute to anyone's Coverdell ESA.

Worksheet 4–1. **MAGI for a Coverdell ESA**

1. Enter your adjusted gross income (Form 1040, line 33)		1. $
2. Enter your foreign earned income exclusion (Form 2555, line 40, or Form 2555–EZ, line 18).	2. $	
3. Enter your housing exclusion (Form 2555, line 34)	3.	
4. Enter the amount of income from Puerto Rico that you are excluding	4.	
5. Enter the amount of income from American Samoa that you are excluding (Form 4563, line 15)	5.	
6. Add the amounts on lines 2, 3, 4, and 5		6.
7. Add the amounts on lines 1 and 6. This is your **modified adjusted gross income**. Enter this amount on line 10 of your Form 8863		7. $

For 2002, if you file a joint return, the limit for each designated beneficiary ($2,000 for 2002) is gradually reduced if your ***modified adjusted gross income*** is more than $190,000 but less than $220,000. If your modified adjusted gross income is $220,000 or more, you cannot contribute to anyone's Coverdell ESA for 2002.

Figuring the limit. To figure the limit for 2001 on the amount you can contribute for each designated beneficiary, multiply $500 by a fraction. The numerator (top number) is your modified adjusted gross income minus $95,000 ($150,000 if filing a joint return). The denominator (bottom number) is $15,000 ($10,000 if filing a joint return). Subtract the result from $500. This is the amount you can contribute for each beneficiary.

To figure the limit for 2002, substitute $2,000 for $500 and, if filing a joint return, substitute $190,000 for $150,000 and $30,000 for $10,000.

Example. Paul, who is single, had modified adjusted gross income of $96,500 for 2001. Paul can contribute up to $450 in 2001 for each child, figured as follows.

1) $96,500 – $95,000 = $1,500
2) $1,500 ÷ $15,000 = 10%
3) 10% × $500 = $50
4) $500 – $50 = $450

Table 4–2. **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 **contribution limit** per designated beneficiary?	$500 in 2001 for each designated beneficiary. $2,000 for 2002.
What if more than one Coverdell ESA has been opened for the same designated beneficiary?	The annual contribution limit is $500 in 2001 ($2,000 for 2002) 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 contribution limit is $500 in 2001 ($2,000 for 2002) per beneficiary, no matter how many individuals contribute.
Can contributions other than cash be made to a Coverdell ESA?	No.
When must contributions stop?	In 2001, no contributions can be made to a beneficiary's Coverdell ESA after he or she reaches age 18. Beginning in 2002, contributions can be made to a Coverdell ESA for a special needs beneficiary after he or she reaches age 18.

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. For 2001, excess contributions are the ***total*** of the following three amounts.

1) Contributions to any designated beneficiary's Coverdell ESA for the year that are more than $500 (or, if less, the total of each contributor's limit for the year, as discussed earlier).
2) All contributions to a designated beneficiary's Coverdell ESA for the year if any amount is also contributed during the year to a qualified state tuition program on behalf of the same beneficiary.
3) 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. For 2001, the excise tax does not apply if the excess contributions (and any earnings on them) are withdrawn before the due date of the beneficiary's tax return (including extensions).

If the beneficiary does not have to file a return, the tax does not apply if the excess contributions (and the earnings) are withdrawn by April 15, 2002.

The withdrawn earnings must be included in the beneficiary's income for the year in which the excess contribution is 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 55, Form 1040.

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 beneficiary's spouse and the following individuals (and their spouses) are members of the beneficiary's family.

- The beneficiary's child, grandchild, or stepchild.
- A brother, sister, half brother, half sister, stepbrother, or stepsister of the beneficiary.
- The father, mother, grandfather, grandmother, stepfather, or stepmother of the beneficiary.
- A brother or sister of the beneficiary's father or mother.
- A son or daughter of the beneficiary's brother or sister.

- The beneficiary's son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law.

CAUTION *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 qualified education expenses (defined earlier) that the beneficiary has in the tax year.

You report withdrawals in Part IV of Form 8606, *Nondeductible IRAs and Coverdell ESAs*.

Tax-Free Withdrawals

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

Taxable Withdrawals

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

Figuring the Taxable Portion of a Withdrawal

The taxable portion is the amount of the 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).

Table 4–3. **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 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. (Beginning in 2002, this does not apply to 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.

3) Multiply the amount of earnings figured in (2) by a fraction. The numerator is the 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 11b, Form 1040A, or on line 16b, Form 1040.

Example. You receive a $600 withdrawal from a Coverdell ESA to which $1,000 has been contributed. The balance in the account before the withdrawal was $1,200. You had $450 of qualified education expenses for the year. Using the steps above, you figure the taxable portion of your withdrawal as follows.

1) $600 × ($1,000 ÷ $1,200) = $500
2) $600 − $500 = $100
3) $100 × ($450 ÷ $600) = $75
4) $100 − $75 = $25

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

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) An educational assistance allowance, or
    c) Payment for the designated beneficiary's education expenses that is excludable from gross income under any law of the United States.
4) Included in income only because the beneficiary waived the tax-free treatment of the withdrawal (as explained later under *Waiver of Tax-Free Treatment*).
5) A return of an excess 2001 contribution (and any earnings on it) made before the due date of the beneficiary's tax return (including extensions). If the beneficiary does not have to file a return, the excess (and any earnings) must be withdrawn by April 15, 2002. The beneficiary must include in gross income for the year the contribution is made, any income earned on the excess contribution.

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

Waiver of Tax-Free Treatment

For 2001, the designated beneficiary can waive the tax-free treatment of the withdrawal and elect to pay any tax that would otherwise be owed on the withdrawal. The beneficiary or the beneficiary's parents may then be eligible to claim a Hope credit or lifetime learning credit for qualified education expenses paid in that tax year. (See chapter 1, *Hope Credit*, and chapter 2, *Lifetime Learning Credit*, to determine if all of the requirements for those credits are met.)

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 (Beginning in 2002, this rule no longer applies 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. (For this purpose, 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. There are no tax consequences as a result of the transfer.

How To Figure the Taxable Earnings

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 distribution must include this amount in income.

5.

Withdrawals From Traditional or Roth IRAs

Introduction

Generally, if you make withdrawals from your traditional or Roth IRA before you reach age $59^1/_2$, you must pay a 10% additional tax on the early withdrawal.

However, you can make withdrawals from your traditional or Roth IRA 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 tax is generally the amount that is not more than the qualified education expenses for the year.

Traditional IRA. A traditional IRA is an IRA that is not a Roth IRA or a SIMPLE IRA. Publication 590, *Individual Retirement Arrangements (IRAs)*, has more information about traditional and Roth IRAs.

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

You can make a withdrawal from your traditional or Roth IRA before you reach age $59^1/_2$ 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.

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, reduce the total ***qualified higher education 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, such as a Pell grant.
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 state tuition program).

After determining the 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.

Qualified higher education expenses. These expenses are tuition, fees, books, supplies, and equipment required for enrollment or attendance at an ***eligible educational institution***. In addition, if the student is at least a ***half-time student***, room and board are qualified higher 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. 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.

6. Education Savings Bond Program

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*** is less than $70,750 ($113,650 if filing a joint return).
- Your filing status is not married filing separate return.

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.

CAUTION *The date a bond is issued may be earlier than the date 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 program.
2) Contributions to a qualified state tuition program (see chapter 8).
3) Contributions to a Coverdell ESA (formerly known as an education IRA) (see chapter 4).

Expenses reduced by certain benefits. You must reduce your qualified higher education expenses by the amount of any of the following benefits received by the student.

1) Tax-free scholarships. See Publication 520.
2) Tax-free withdrawals from a Coverdell ESA (formerly known as an education IRA).
3) 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) Benefits under a qualified state tuition program, or
   c) Tax-free employer-provided educational assistance.
4) 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 on line 6c, Form 1040 (or Form 1040A).

Modified adjusted gross income. For most taxpayers, modified adjusted gross income (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 19 of that form figured without taking into account any savings bond interest exclusion or student loan interest deduction.

MAGI when using Form 1040. If you file Form 1040, your MAGI is the AGI on line 33 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 or deduction,
3) Exclusion of income for bona fide residents of American Samoa,
4) Exclusion of income from Puerto Rico,
5) Exclusion for adoption benefits received under an employer's adoption assistance program, and
6) Deduction for student loan interest.

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 and enter the total on Form 8815, line 9, as your modified AGI.

CAUTION *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), 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 qualified higher education expenses for the year, all of the interest on the bonds may be tax free. If the total you receive when you cash in the bonds is more than the expenses, 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 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 1. In February 2001, Mark and Joan, a married couple, cashed a qualified series EE U.S. savings bond they bought in November 1992. They received proceeds of $9,000, representing principal of $6,000 and interest of $3,000. In 2001, they paid $7,500 of their daughter's college tuition. They are not claiming an education credit for that amount, and they do not have a Coverdell ESA (formerly known as an education IRA). Their modified adjusted gross income for 2001 was $80,000.

They can exclude $2,500 ($3,000 × ($7,500 ÷ $9,000)) of interest in 2001. They must pay tax on the remaining $500 ($3,000 – $2,500) 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 $55,750 and $70,750 (between $83,650 and $113,650 for joint returns). 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 except that Mark and Joan have a modified adjusted gross income of $101,650. In this example, they can exclude $1,000 (line 14 of Form 8815 shown on the next page) of interest in 2001.

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.

Example

Form **8815**

Department of the Treasury
Internal Revenue Service

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.**

OMB No. 1545-1173

2001

Attachment Sequence No. **57**

Name(s) shown on return | **Your social security number**

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
Mark & Joan 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 2001 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 2001 for the person(s) listed in column (a) of line 1. See instructions	**3**	
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 **cashed during 2001**	**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**	2,500
9	Enter your modified adjusted gross income. See instructions — **9** 101,650 **Note:** *If line 9 is $70,750 or more if single or head of household, or $113,650 or more if married filing jointly or qualifying widow(er), **stop.** You **cannot** take the exclusion.*		
10	Enter: $55,750 if single or head of household; $83,650 if married filing jointly or qualifying widow(er) — **10** 83,650		
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**	1,500
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 2001 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 2001 that were issued after 1989.

2. You paid qualified higher education expenses in 2001 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: $70,750 if single or head of household; $113,650 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 2001.
- 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.

For Paperwork Reduction Act Notice, see back of form. Cat. No. 10822S Form **8815** (2001)

7. 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 for undergraduate-level courses was scheduled to end for courses beginning after December 31, 2001.

This benefit has been extended and, beginning in 2002, it also applies to 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.

CAUTION *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. For 2001, the payments must be for undergraduate-level courses that begin before January 1, 2002. 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.
3) For 2001, graduate-level courses normally taken under a program leading to a law, business, medical, or other advanced academic or professional degree.

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 which 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*.

8.

Qualified State Tuition Program (QSTP)

Important Changes for 2002

Beginning in 2002, what were formerly known as qualified state tuition programs have been renamed and can be established and maintained by educational institutions.

Name change. Qualified state tuition programs (QSTPs) are renamed qualified tuition programs (QTPs).

Distributions from state-maintained QTPs. 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 for higher education. For more information, see *Are Distributions Taxable* in this chapter.

QTPs maintained by 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 State Tuition Program*, in this chapter.

Rollovers of QTPs to same beneficiary. Amounts in a QTP can be rolled over, tax free, to another QTP set up for the same beneficiary. However, the 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 for the same beneficiary.

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

Qualified expenses. Calculation of the amount that is considered reasonable for room and board expenses has been changed. You must contact the educational institution for their qualified room and board costs. For more information, see *Qualified higher education expenses* in this chapter.

Special needs beneficiaries. 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 institution. For more information, see *Qualified higher education expenses* in this chapter.

Coordination with Coverdell ESAs. You can make contributions to Coverdell ESAs and QTPs in the same year for the same beneficiary. For more information, see the *Caution*, later.

Introduction

Certain states and, beginning in 2002, educational institutions maintain programs that allow you to either prepay a student's tuition or contribute to an account established for paying a student's qualified higher education expenses (defined later). If you prepay tuition, the student (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 educational institution that established and maintains it.

For 2001, no tax is due on earnings based on the prepayments or contributions unless the earnings were distributed. The student pays tax on the earnings if they were distributed. Because payments and contributions were not deducted, any tax due on them has already been paid. Therefore, if amounts were distributed from the program, tax is due only on the part of the distribution that represents earnings on the payments or contributions. 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 State Tuition Program?

A qualified state tuition program (QSTP) is a program set up to allow you to either prepay a student's tuition or contribute to an account established for paying a student's ***qualified higher education expenses*** at an ***eligible educational institution***. Prior to 2002, a QSTP 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 educational institutions. The program must meet certain requirements. Your state government or the educational institution in which you are interested can tell you whether or not they participate in a QTP.

Qualified higher education expenses. For 2001, these are the tuition, fees, books, supplies, and equipment required for enrollment or attendance at an eligible educational institution (defined below).

In 2001, they also include the reasonable costs of room and board for a ***beneficiary*** who is at least a half-time student. The cost of room and board is generally considered reasonable if it is not more than either:

1) The school's posted room and board charge, or
2) $2,500 per year for students living off-campus and not at home.

Note. Calculation of the amount that is considered reasonable for room and board expenses has been changed beginning in 2002. You must contact the educational institution for qualified room and board costs.

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

Beneficiary. The beneficiary is generally the student (or future student) for whom the QTP is intended to provide benefits. The 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 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.

CAUTION *For 2001 no contributions could be made to a Coverdell ESA (formerly known as an education IRA) on behalf of a beneficiary if any amount was contributed during 2001 to a QTP on behalf of the same beneficiary. Any amount contributed to the Coverdell ESA must be treated as an excess contribution to the Coverdell ESA. Coverdell ESAs are discussed in chapter 4.*

Are Distributions Taxable?

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

Generally, ***for 2001***, the beneficiary must include in income any earnings distributed from a QSTP. The beneficiary does not have to include in income any return of the investment in the plan.

Generally, ***for 2002***, the beneficiary 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 earnings are used for higher education. However, the beneficiary must include in income any earnings distributed from a QTP if the plan was established and maintained by one or more educational institutions. The beneficiary does not have to include in income any return of the investment in the plan.

Determining earnings and return of investment. If you received a distribution in 2001, how you determine the part of the distribution that is earnings and the part that is a return of investment in the plan depends on whether:

1) Contributions were made to an account established to meet the qualified higher education expenses of a designated beneficiary, or
2) Tuition credits or certificates were purchased that entitle a designated beneficiary to the waiver or payment of his or her qualified higher education expenses.

In-kind distributions. Any in-kind distribution (such as a waiver of tuition) furnished to a designated beneficiary under a QTP is considered a distribution to the beneficiary.

Distributions From Account

If contributions were made to an account established to meet the qualified higher education expenses of a beneficiary, you determine the part of any distribution that is earnings by:

1) Dividing the amount of the distribution by the account balance as of the end of the year (including all amounts distributed during the year), and then
2) Multiplying the result of (1) by the earnings in the account as of the end of the year (including all earnings distributed during the year).

The remaining portion of the distribution is a tax-free return of investment.

Example. In 1996, your parents opened a college savings account with a QTP on your behalf. Your parents contributed $18,000 to the account, including processing fees. On December 31, 2001, the balance in the account is $24,000 (including amounts distributed in 2001).

In 2001, you enrolled at a 4-year university. The QTP made distributions on your behalf to the university in August for the fall semester and in December for the spring semester. Tuition for full-time attendance at the university is $6,600 for the academic year. The only expense covered by the QTP distributions was tuition.

You figure the part of the distributions that is earnings by:

1) Dividing the amount of the distributions ($6,600) by the account balance as of the end of the year ($24,000, which includes all amounts distributed during the year), and then
2) Multiplying the result (.275) by the earnings in the account as of the end of the year ($6,000, which includes all earnings distributed during the year).

The earnings are $1,650. This is illustrated in *Worksheet 8–1*.

Worksheet 8–1. **Earnings Part of Distributions From Account**

1. Distributions in 2001	$ 6,600
2. Account balance as of 12/31/2001	24,000
3. Divide line 1 by line 2	.275
4. Earnings as of 12/31/2001	6,000
5. Multiply line 3 by line 4. **This is the part of the 2001 distributions that is earnings**	$ 1,650

Distributions Related To Credits or Certificates

If tuition credits or certificates were purchased that entitle the beneficiary to the waiver or payment of qualified higher education expenses, the part of any distribution that is earnings is the value, at the time of distribution, of the credits, hours, or other units of education distributed minus the return of investment portion of the distribution. The value of the credits, hours, or other units of education may be based on the tuition received or the cash distributed.

You determine the return of investment portion of the distribution by:

1) Dividing the investment in the account at the end of the year in which the distribution is made (including any return of investment made during the year) by the number of credits, hours, or other units of education in the account at the end of the calendar year (including all credits, hours, or other units of education distributed during the calendar year), and then

2) Multiplying the result of (1) by the number of credits, hours, or other units of education distributed during the current calendar year.

Example. In 1996, your parents opened a QTP account on your behalf. Through the account they purchased eight units of education equivalent to eight semesters of tuition for full-time attendance at a public 4-year university covered by the QTP. They contributed $16,000 ($2,000 for each unit) that included payment of processing fees.

In 2001, you enrolled at the university. The QTP made distributions on your behalf to the university in August for the fall semester and in December for the spring semester. Tuition for full-time attendance at the university is $5,200 for the academic year. The only expense covered by the QTP distributions was tuition.

To figure the earnings part of the distribution, you must figure the return of investment portion and subtract that amount from the current value of the distributed units.

Worksheet 8–2. **Earnings Part of Distributions Related To Credits or Certificates**

1. Current value of 2 units distributed in 2001	$ 5,200
2. Investment in the account as of 12/31/2001	16,000
3. Number of units in account as of 12/31/2001	8
4. Divide line 2 by line 3. This is the per unit investment	2,000
5. Number of units distributed in 2001	2
6. Multiply line 4 by line 5. This is the investment portion of the 2001 distributions	4,000
7. Subtract line 6 from line 1. **This is the part of the 2001 distributions that is earnings**	$ 1,200

You figure the part of the distributions that is a return of your parents' investment by:

1) Dividing the investment in the account at the end of the year in which the distribution is made ($16,000 — which includes any return of investment made during the year) by the number of credits, hours, or other units of education in the account at the end of the calendar year (8 — which includes all credits, hours, or other units of education distributed during the calendar year), and then

2) Multiplying the result of (1) by the number of credits, hours, or other units of education distributed during the current calendar year (2).

You then subtract the result of (2) above from the current value of the distributed units.

This is illustrated in *Worksheet 8–2*.

Penalty on Refund of Earnings

Generally, distributions must be used to pay the qualified higher education expenses (defined earlier) of the beneficiary.

Penalty. There is a penalty on any refund of earnings in 2001 that does not meet ***at least one*** of the following conditions.

1) The refunded earnings are used to pay qualified higher educational expenses of the beneficiary.

2) The refund of earnings is made because of the death or disability of the beneficiary.

3) The refund of earnings is made because the beneficiary received a scholarship, a veterans educational assistance allowance, or another nontaxable payment (other than a gift, bequest, or inheritance) for educational expenses. This only applies to the part of the refund that is not more than the scholarship, allowance, or other payment.

Can You Transfer Amounts or Change Beneficiaries?

Amounts can be transferred to other QTPs and beneficiaries can be changed.

Amounts in a QTP can be transferred tax free to the QTP of another beneficiary. The transfer must be completed within 60 days of the distribution and the other beneficiary must be a family member (as defined later) of the beneficiary from whose program the transfer is made.

Starting in 2002, amounts in a QTP of one beneficiary can be transferred tax free to another QTP for the same beneficiary. However, the transfer (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 for the same beneficiary.

The beneficiary of a QTP can be changed. However, the new beneficiary must be the existing beneficiary's spouse or one of the family members listed next.

Family members. If the beneficiary does not use amounts in the QTP, the amounts can be transferred tax free to the 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) The spouse of any individual listed above.

Beginning in 2002, for purposes of tax free transfers (rollovers) and changes of designated beneficiaries, the definition of family members is expanded to include first cousins of the beneficiary.

9.

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 the IRS at **1–800–829–1040.**
- 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:

- Find answers to questions you may have.
- Download forms and publications or search for forms and publications by topic or keyword.
- 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.
- 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.**
- *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 evaluate the quality of our telephone services in several ways.

- A second IRS representative sometimes monitors live telephone calls. That person only evaluates the IRS assistor and does not keep a record of any taxpayer's name or tax identification number.
- We sometimes record telephone calls to evaluate IRS assistors objectively. We hold these recordings no longer than one week and use them only to measure the quality of assistance.
- We value our customers' opinions. Throughout this year, we will be surveying our customers for their opinions on our service.

Walk-in. 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.

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. 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 **www.irs.gov.** The first release is available in mid-December and the final release is available in late January.

IRS Publication 3207, *Small Business Resource Guide,* is an interactive CD-ROM that contains information important to small businesses. It is available in mid-February. You can get one free copy by calling **1–800–829–3676** or visiting the IRS web site at **www.irs.gov.**

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 2001.
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 the publication for more complete information.

Appendix A. Illustrated Example of Education Credits

Dave and Valerie are married and file a joint tax return. For 2001, they claim exemptions for their two dependent children on their tax return. Their modified adjusted gross income is $82,000. Their tax is $9,475. Their son, Sean, will receive his bachelor's degree in psychology from the state college in May 2002. Their daughter, Corey, enrolled full-time at that same college in August 2000 to begin working on her bachelor's degree in physical education. In July 2001, Dave and Valerie paid $2,200 in tuition costs for each child for the fall 2001 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 2001 for academic periods beginning in 2001 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 2001 for academic periods beginning in 2001 qualify for the Hope credit.

Dave and Valerie figure their tentative education credits for 2001, $1,940, as shown in the completed Form 8863. They cannot claim the full amount because their modified adjusted gross income is more than $80,000. They carry the amount from line 18 of Form 8863 to line 46 of Form 1040, and they attach the Form 8863 to their return. ■

Form **8863**

Department of the Treasury
Internal Revenue Service

Education Credits (Hope and Lifetime Learning Credits)

▶ See instructions on pages 2 and 3. ▶ Attach to Form 1040 or Form 1040A.

OMB No. 1545-1618

2001

Attachment Sequence No. **50**

Name(s) shown on return	Your social security number
Dave and Valerie Jones	987 00 6543

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, Last	(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)		**2**	1,000		500
3	Tentative Hope credit. Add the amounts on line 2, columns (d) and (f) . . . . ▶				**3**	1,500

Part II **Lifetime Learning Credit**

4	(a) Student's name (as shown on page 1 of your tax return) First	Last	(b) Student's social security number (as shown on page 1 of your tax return)	(c) Qualified expenses. See instructions
Caution: *You cannot take the Hope credit and the lifetime learning credit for the same student.*	Sean	Jones	246 00 9731	2,200

5	Add the amounts on line 4, column (c), and enter the total	**5**	2,200
6	Enter the **smaller** of line 5 or $5,000	**6**	2,200
7	Tentative lifetime learning credit. Multiply line 6 by 20% (.20) . . . . ▶	**7**	440

Part III **Allowable Education Credits**

8	Tentative education credits. Add lines 3 and 7.			**8**	1,940
9	Enter: $100,000 if married filing jointly; $50,000 if single, head of household, or qualifying widow(er)	**9**	100,000		
10	Enter the amount from Form 1040, line 34 (or Form 1040A, line 20)*	**10**	82,000		
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 42 (or Form 1040A, line 26)			**15**	9,475
16	Enter the total, if any, of your credits from Form 1040, lines 43 through 45 (or from Form 1040A, lines 27 and 28).			**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**	9,475
18	**Education credits.** Enter the **smaller** of line 14 or line 17 here and on Form 1040, line 46 (or Form 1040A, line 29) . . . . ▶			**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 4. Cat. No. 25379M Form **8863** (2001)

Appendix B — Highlights of Tax Benefits for Higher Education for Tax Year 2001

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	Coverdell ESA[1]	Traditional and Roth IRAs[1]	Student Loan Interest	State Tuition Programs	Education Savings Bond Program[1]	Employer's Educational Assistance Program[1]
What is your benefit?	Credits can reduce the amount of tax you must pay		Earnings are not taxed	No 10% additional tax on early withdrawal	You can deduct the interest	Earnings are not taxed	Interest is not taxed	Employer benefits are not taxed
What is the annual limit?	Up to $1,500 per student	Up to $1,000 per family	$500 contribution per beneficiary	Amount of qualifying expenses	$2,500	None	Amount of qualifying expenses	$5,250
What expenses qualify besides tuition and required enrollment fees?	None		Books Supplies Equipment Room & board if at least a half-time student Payments to state tuition program	Books Supplies Equipment Room & board if at least a half-time student	Books Supplies Equipment Room & board Trans-portation Other necessary expenses	Books Supplies Equipment Room & board if at least a half-time student	Payments to Coverdell ESAs Payments to state tuition programs	Books Supplies Equipment
What education qualifies?	1st 2 years of under-graduate	All undergraduate and graduate						Under-graduate
What are some of the other conditions that apply?	Can be claimed only for 2 years Must be enrolled at least half-time in a degree program		Cannot contribute to a Coverdell ESA and state tuition program in the same year Must withdraw assets at age 30		Applies to 1st 60 months of required interest Must have been at least half-time student in a degree program	Beneficiary must pay tax on withdrawn earnings	Applies only to qualified series EE bonds issued after 1989 or series I bonds	
In what income range do benefits phase out?	$40,000 – $50,000; $80,000 – $100,000 for joint returns		$95,000 – $110,000; $150,000 – $160,000 for joint returns	There is no phaseout	$40,000 – $55,000; $60,000 – $75,000 for joint returns	There is no phaseout	$55,750 – $70,750; $83,650 – $113,650 for joint returns	There is no phaseout

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

■