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USA Tax Benefits Associated with Educational Costs

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We are seeing renewed interest in the tax benefits under USA law which relate to the costs of education. Following is an outline of those currently available.

These benefits may be available to families who are in whole or part US persons[1] (subject to the USA tax regimes) even where we reside and work outside of the USA. Further, the benefits may be available where the child/student attends some educational institutions wholly located outside of the USA.

Finally, there are estate planning benefits available which may mitigate USA estate/gift taxation. Indeed, for some, these benefits may exceed the value of any income tax savings.

Special Benefits Encouraging Savings for Higher Education

Coverdell Education Savings Accounts (f/k/a education IRA)

1. These accounts must take the form of a tax exempt trust organized in the USA. Thus, one is limited to those financial institutions which will perform that role. Because these are tied to USA tax law, the only institutions of which we are aware which offer them are USA based financial institutions.

[1] The term "US persons" is used throughout this memo. US Persons are citizens of the USA, holders of a USA issued "green card" (permanent residency) and certain other circumstances. US persons are treated exactly like citizens of the USA where their global income is subjected to USA income tax and their wealth to USA estate/gift taxes. In some cases, all or a portion of non-US persons' wealth may be subjected to USA estate taxes.

   a. The beneficiary (future student) must be identified when the trust is created and must be under the age of 18 or a special needs person.

2. This provision is set to expire on 31 December 2012. Thus, unless the US Congress acts, the maximum possible contributions to these accounts are now US$2,000.00.

3. Contributions are **not** deductible and may not, in the aggregate, exceed US$2,000.00 per calendar year. These contributions must be made in cash.

   a. For 2010, the US$2,000.00 contribution limit is phased to zero as adjusted gross income approaches US$190,000.00 reaching zero at US$220,000.00 for married joint filers; US$95,000.00 and US$110,000.00 when single.[2]

   b. There is no relationship limitation with respect to the person making the contribution and the named beneficiary. Thus, grandparents and others may make contributions.

   c. Contributions made by non-corporeal persons (*e.g.*, corporations, non-profits, etc.) are not subject to the income limitations. However, the maximum aggregate contributions from all donors may not exceed US$2,000.00 annually.

4. Distributions from the account are not taxable to parent or child/student so long as they are used for "qualified educational expenses" net of any scholarships or similar.

   a. Qualified education expenses include tuition, fees, books, supplies, equipment and special needs services for elementary, secondary, undergraduate and graduate education.

      i. For undergraduate and graduate level courses at an eligible institution, qualified education expenses include room and board so long as the student is enrolled at least half time.

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[2] The term "adjusted gross income" is used throughout this memo. It is approximately the last line on page 1 of Form 1040. Many but not all of these income limitations in the Internal Revenue Code are adjusted annually for inflation.

b. Distributions will be taxed to the extent the distributions are not used for qualified education expenses, including a penalty, and to the extent the non-qualified distributions source in the non-taxed earnings accrued within the account.

c. The account balance must be zero within 30 days of the child/student beneficiary's 30th birthday or 30 days after the child/student beneficiary's death.

i. Unused balances in these accounts may be rolled over into new accounts for other family members of the child/student beneficiary.

5. An eligible educational institution is generally an accredited postsecondary educational institution offering credit toward a bachelor's degree, an associate's degree, a graduate level or professional degree or other postsecondary credential. Also included are expenses for elementary and secondary education as well as vocational education.

a. While not entirely clear, some institutions not located within the USA may qualify.

Comments: These accounts are generally opened in the form of a USA bank, brokerage or mutual fund account where the bank or other institution acts as trustee.

These may have some benefit where the accounts are opened when the child/student is very young and household income is below the thresholds noted above. However, given the sunset provision which effectively limits the total contributions to US$2,000.00, there may be very little practical benefit.

There is no current deduction for the contributions but the earnings within the account (capital gains, interest and dividends) eventually escape taxation to the extent used for qualified education. As the child/student approaches the age of entry into the educational institutions (especially college), the benefits of these accounts become negligible. Indeed, these accounts may actually be counterproductive from a USA income tax point of view where they may preclude the use of certain current income tax credits discussed below.

One should use great care here in evaluating the costs associated with these accounts including those not associated with taxation. These are established in banks, brokerage houses or similar. The fees and commissions can be considerable including fees which are not readily apparent such as those imbedded in mutual funds. Our US investment advisor tells us they charge US$75.00 annually to maintain these accounts in addition to otherwise customary fees and commissions. In the first year, the US$75.00 is 3.75% of the US$2,000.00 account balance. Thus, the annual fees could exceed any interest and dividend income. Indeed, given that the maximum contributions as of November 2011 are US$4,000.00, the fees could exceed income and gains over the life of the account.

Mutual funds are often used to fund these accounts or even privately required. Our US investment advisor tells us they will accept these accounts in a self-directed form with respect to the actual investments within certain limits. This would avoid the necessity of mutual funds. As a practical matter, one might well be limited to mutual funds as investment vehicles if only due to the US$2,000.00 annual contribution limit. It is very difficult to invest US$2,000.00 unless one limits the choices to certificates of deposit, mutual funds or similar.

With respect to the references to our US investment advisor, we suspect their fees, terms and conditions are similar to others. We cite them here as we have accounts with them and access to their brokers. Hence, asking these questions of them is relatively easy for us.

Qualified Tuition Programs ("QTP") a/k/a a "529 Plan"

1. These are programs where a person can prepay tuition or make contributions on behalf of a child/student beneficiary for payment of future qualified higher education expenses.

    a. These programs must be maintained by a USA state, state agency or eligible educational institution. Thus, as a practical matter, one is likely limited to educational institutions located in the USA.

    b. At least in theory, the payments made to these programs are intended to be discounted as the funds are isolated for the benefit of the state or institution to provide future education. They are, as we generally understand them, intended to remove all or some of the inflation risk with respect to the expected future levels of tuition and other eligible costs. Whether these "intended" or "represented" benefits are actually achieved turn on the terms of individual contracts, actual performance and future expectations proving reasonably accurate.

2. These contributions are **not** deductible from the donors' or others' taxable income when the contributions are made.

a. Unlike the Coverdell program above, there are **no** income or other limitations. One can contribute within the confines of the Coverdell while directing any additional funds to these QTPs.

b. The cumulative contributions may not exceed the amount necessary for the qualified higher education expense of the beneficiary.

c. There is no relationship limitation with respect to the person making the contribution and the named beneficiary. Thus, grandparents and others may make contributions.

3. Distributions must be used for qualified education expenses and are not subject to income tax.

   a. Qualified education expenses are similar to those defined above for a Coverdell account. However, these distributions are limited to postsecondary education.

   b. Distributions not used for qualified education expenses are subject inclusion in income and certain penalties similar to the Coverdell accounts.

   c. Unused amounts can also be assigned to other family members of the child/student. Special procedures apply.

4. Contributions to these accounts by a person other than the beneficiary are subject to USA gift tax. There is a small mitigating factor in the gift tax rules.

Comments: These accounts must be maintained by the designated educational institutions or the various USA states. When these were first introduced, the various states and educational institutions imposed limitations including restricting the use of these accounts to pay tuition limited to a particular educational institution. Especially when the child/student is very young, it really was not practical for a parent to identify Boston College or any other institution as the best institution of higher learning when a child reaches the requisite age. As I recall, some of these “private” limitations were eased over the years.

Like the Coverdell accounts, these accounts have little value unless they are established when the child/student is very young.

Where the family is of mixed nationality as to citizenship and residency, there may be better solutions with fewer restrictions. *E.g.*, a spouse who is not a US person, as defined, might well hold the family's savings for their children's education.

The only benefit to these accounts is the lawful avoidance of USA income tax on the earnings implicit in these accounts. Those earnings are likely to be in the form of interest, dividends and capital gains, including those implicit in the QTPs. Thus, where one spouse/parent is not a US person subject to USA income taxation and the resident country has a favorable tax regime, it may be better for that non-US person spouse/parent to hold the wealth intended for their children's education while not electing to file a joint USA income tax return with the US person spouse.

To pick on Costa Rica, Costa Rica imposes a final withholding tax of 8% to 15% on interest and dividend income sourced in Costa Rica; there is a zero percent income tax on capital gains, as defined, regardless of source or holding period; and there is zero Costa Rican income tax with respect to income (interest and dividends included) sourced outside of Costa Rica. There may be non-Costa Rican withholding taxes associated with interest and dividends sourced outside of Costa Rica. Thus, the global income tax where the non-US person Costa Rican citizen spouse holds the investment assets intended for education may be no more than that incurred through these USA tax gimmicks but with zero restrictions. Further, the current tax credits discussed below may well still be available to the US person spouse or their children.

Of course there would be differing results (for good or ill) where countries other than Costa Rica are involved.

The key differences between the Coverdell plans and the QTP arrangements are:

1. The annual contributions (one left unless statutorily extended) permitted into a Coverdell plan are small. The QTP arrangements have no annual limit. Both are limited to the costs of education.

2. The Coverdell distributions may be used for elementary and secondary education (grades kindergarten through 12, in the USA education regimes). The QTP arrangements are limited to college and higher education.

Finally, a key difference between these savings schemes and the credits discussed below is the savings schemes can be used to pay for room and board while the credit schemes may not.

Gift Taxes[3]

1. The USA asserts a tax on gifts made by US persons to people other than our USA citizen spouses where those cumulative annual gifts exceed US$13,000.00 in 2011.[4] This US$13,000.00 cumulative annual exception is limited to gifts of a "present interest" in property including, but not limited to, stocks, bonds and cash. A gift also occurs where one person pays another person's obligations such as a grandparent paying a grandchild's rent on an apartment. The literal law would also include the value of holiday and birthday gifts in this cumulative amount. Thus, we typically suggest using a slightly lower amount when structuring tax driven gifting strategies. This limit is adjusted from time to time for inflation.

    a. This US$13,000.00 annual limit is effectively extended for amounts paid on behalf of another **directly** to an educational institution for tuition. The same is true with respect to amounts paid **directly** to health care providers for medical services. Directly means the donor must write the check to the institution; not to the student or other beneficiary or the student/beneficiary's parents or one of the tax driven accounts mentioned above, etc. – there are no exceptions. There is no relationship requirement with respect to the person making these payments and the person who benefits.

[3] Not outlined in this memo with respect to estate and gift tax issues are a plethora of annual or periodic or event driven forms which may need to be filed with the Internal Revenue Service in connection with gifts. Failing to file the relevant forms can result in large penalties, among other matters.

[4] There is a key but confusing issue here. The USA tax law generally does not apply to people who are not US persons. Thus, my Costa Rican wife who does not have US greencard or similar can make unlimited gifts, including to me and our children, without any USA gift tax return filing or other limitation on her part. She would incur no gift tax. Certainly, in this case, I would have to file a disclosure form reflecting receipt of the gift from a non-US person with the Internal Revenue Service and, likely, so would our children no matter the age of our children. But this is mere disclosure with no consequent gift tax incurred. There is no Costa Rican issue as Costa Rica does not impose a tax on gifts given or received. Where these facts are modified as to the nation state citizenship of my hypothetical wife, the results could differ. Thus, one should always consult local country tax counsel **in advance** of making gifts or similar.

On the other hand, I am a US person. Thus, I **cannot** make unlimited tax free gifts to either my non-US person spouse or our children without a US gift tax issue including the filing of returns. One of several issues in the above example is I do not have an unlimited ability to make gifts to my non-US **citizen** wife without incurring a gift tax. This is very different than the unlimited gifts without gift tax permitted where both spouses are USA citizens – greencards and similar do not count here but, rather, my spouse must be a citizen of the USA in order to "avoid" USA gift taxes on gifts from me to her.

b. The US$13,000.00 annual gift exemption from USA gift tax applies to each donor with respect to each beneficiary. Thus, for example, US person grandfather and US person grandmother can make tax exempt gifts totaling US$26,000.00 annually to each grandchild whether or not the grandchildren are US persons. Care needs to be used in structuring the actual source of funds and means of remittance. These same grandparents could also include each grandchild's tuition with no gift tax due so long as they wrote a check payable directly to the school.

2. There is an implicit exception to these rules concerning taxable gifts. Taxable gifts do **not** include the "support and maintenance" obligations one person may have with respect to another under local law. Thus, I suspect it is fair to say that nearly all of the developed and developing world requires parents, as a matter of law, to support their children (as defined with respect to various ages of maturity and other factors). However, what constitutes legally required support may differ. *E.g*., within the span of my career, I recall debating whether a doctorate degree constituted "required support and maintenance" when the cost was funded by a parent. I do not think we would debate that in the USA anymore but one might in other regions of the world.

   a. Adopted children are treated no differently than natural children in USA tax law.

   b. Unless legally adopted, the child of my wife and another is not my child for USA income and transfer tax purposes regardless of family living circumstance or my feelings and personal relationship with that child. Thus, should I use personal resources for this child's education, those transfers could well be viewed as taxable gifts subject to USA transfer tax where these same payments with respect to my natural or adopted child would not be viewed as taxable gifts.

   c. Legally imposed custody relationships may alter this result. For example, my parents die prematurely and I am charged under local law (including a private but judicially enforceable agreement) with support and maintenance of my teenage sibling. Money spent for the support and maintenance of my underage sibling is not a gift for USA transfer tax purposes in this circumstance.

Comments: These gift tax provisions are often used by wealthier grandparents or similar to effectively make intergenerational wealth transfers without transfer tax (estate and gift). Especially given the cost of education these days, the cumulative sums can be considerable. The net present value of the transfer tax savings with respect to these transfers can be very meaningful where, under current law, the grandparent's net worth exceeds US$5 million. Commencing 1 January 2013, this US$5 million threshold will become US$1 million unless the US Congress acts.

One may also need to consider the USA Generation Skipping Tax.

For USA income tax purposes, receipt of a gift is **not** taxable income nor is receipt of a bequest from an estate. Likewise, gifts and bequests are **not** deductible from the donor's otherwise taxable income. There are special rules, including certain USA withholding taxes, where the benefits from a USA estate or trust inure to the benefit of non-US persons. There are also special filing requirements where a US person receives a gift from a non-US person but this filing requirement does not generate a tax.[5]

Where the relationships and location of the parties involved in a gift span nation states, one should also consult a qualified tax advisor with respect to any non-USA income or transfer tax issues.

Special Provisions for a Current Credit of Education Expenses

Where the payments for the educational expenses source in one or both of the special savings accounts discussed above, the expenses are **not** eligible for the following credits. The gift tax issues still apply especially where the person paying for these items is also not the parent of the child/student. The credits below would generally not be available to someone other than the parent, the child/student or the spouse of the child/student.

The benefits below may be claimed by only one taxpayer. The eligible taxpayers are likely the parents and the child/student. One or the other may claim the credit but not both. The amount of the credit is limited as income increases. Thus, it is not uncommon for a parent to be "capped out" with respect to using these benefits.

One key to the following discussion is the use of the terms "credit" or "deduction". A credit is a direct dollar for dollar reduction of income taxes otherwise due sometimes also resulting in a dollar for dollar cash refund. A deduction, on the other hand, is an amount which is used to reduce otherwise taxable income.

[5] There is a mountain of other filing requirements, tax results and other issues where a trust is a "foreign trust", as defined for USA tax purposes, with even the **possibility** that a beneficiary **could** be a US person, as defined.

Thus, a credit is nearly always worth more in tax savings than a deduction of a comparable monetary amount.

The American Opportunity Tax Credit

1. This credit was originally scheduled to expire for tax years beginning after 31 December 2010. It has been extended through 31 December 2012.

2. In general, it provides for the credit directly against US Federal income tax of 100% of the first US$2,000.00 of tuition expenses plus 25% of the next US$2,000.00. Thus, the maximum credit is US$2,500.00.

3. It is available for the first four years of a student's post secondary education, *i.e*., college or the university in the USA education regimes.

4. Qualified expenses are tuition and related expenses including course materials (not room and board, many books and fees or transportation) for the taxpayer, the taxpayer's spouse or the taxpayer's dependent (typically a child 23 years of age or less but not necessarily limited to that relationship). These amounts are reduced for any expenses reimbursed through the savings programs discussed above or scholarships.

5. The child/student is eligible if:

    a. He is enrolled at least half time in a program which leads to a degree or similar.

    b. He has not been convicted of a US Federal or state felony class drug offence for either possession or distribution.

6. A qualified institution is defined as one eligible to participate in a student aid program administered by the US Department of Education. This does **not**, *per se*, preclude all educational institutions wholly located outside of the USA.

7. Up to 40% of the credit is refundable (*i.e.*, if your tax is zero, you still may get a cash refund for up to 40% of this credit). The replacement credits discussed below which remain after 31 December 2012 are not refundable but, rather, may only be used to reduce to zero US Federal income tax otherwise due. The refundable portion of this credit is not available to a child where a child is subject to the "kiddie tax" which references the

parents' marginal income tax rates then applying those higher rates to the child. The "child" in this circumstance could be up to age 23.

8. This credit phases out for taxpayers with adjusted gross income which exceeds US$80,000.00 resulting in zero credit when income hits US$90,000.00 for single people; US$160,000.00 and US$180,000.00 for joint married filers. This credit is available to the taxpayer who is a parent **or** the child/student. Implicitly, it could be claimed by the child/student's spouse where they elect to file jointly. This credit is not available where married persons elect to file separately. It is not available to the child/student if the child/student can be claimed as a dependent on another's return; typically, but not limited to, a parent's return.

9. Commencing in 2010, the non-refundable portion will be available to offset the alternative minimum tax as well as the regular tax.

The Hope Scholarship Credit (applies to tax years other than 2009 through 2012)

1. In 2013, this Hope Scholarship Credit will effectively replace the American Opportunity Tax Credit discussed above originally scheduled to expire in 2010. The American Opportunity Tax Credit's expiration (plus a few other nuances) was extended to 2012 in the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010. Thus, until 2013, one uses the American Opportunity Tax Credit; **not** this Hope Scholarship Credit.

2. Originally, this is a tax credit for 100% of the first US$1,000.00 of qualified tuition expenses plus 50% of the second US$1,000.00 paid during the year to a qualified educational institution. Thus, the maximum credit is US$1,500.00. The limitation amounts are adjusted annually for inflation. This credit is available to offset both the regular income tax and the alternative minimum tax.

3. Qualified expenses are tuition and related expenses (not room and board, not course materials including books and not fees or transportation) for the taxpayer, the taxpayer's spouse or the taxpayer's dependent (typically a child 23 years of age or less but not necessarily limited to that relationship). These amounts are reduced for any expenses reimbursed through the savings programs above or scholarships.

4. A qualified institution is defined as one eligible to participate in a student aid program administered by the US Department of Education. This does **not**, *per se*, preclude all educational institutions wholly located outside of the USA.

5. The child/student is eligible if:

    a. He has not elected to claim the Hope Scholarship Credit or the American Opportunity Tax Credit for any two earlier tax years.

    b. He has not completed the first two years of postsecondary education before commencing the current year.

    c. He is enrolled at least half time in a program which leads to a degree or similar.

    d. He has not been convicted of a US Federal or state felony class drug offence for either possession or distribution.

6. The allowable amount of the credit is reduced where adjusted gross income reaches US$50,000.00 phasing to zero when adjusted gross income hits US$60,000.00 if single; US$100,000.00 to US$120,000.00 when married filing jointly. This credit is available to the taxpayer who is a parent **or** the child/student. Implicitly, it could be claimed by the child/student's spouse where they elect to file jointly. This credit is not available to married taxpayers who elect to file separate tax returns. If the child/student claims the credit, that child/student may not also be claimed as a dependent on another's US Federal income tax return including his parent's return.

Lifetime Learning Credit

1. This is equal to 20% of the amount of qualified tuition expenses paid up to the first cumulative US$10,000.00 to a qualified educational institution. Thus, the maximum lifetime benefit is US$2,000.00.

2. Qualified expenses are tuition and related expenses (not room and board, many books and fees or transportation) for the taxpayer, the taxpayer's spouse or the taxpayer's dependent (typically a child 23 years of age or less but not necessarily limited to that relationship). These amounts are reduced for any expenses reimbursed through the savings programs discussed above or scholarships.

3. A qualified institution is defined as one eligible to participate in a student aid program administered by the US Department of Education. This does **not**, *per se*, preclude all educational institutions wholly located outside of the USA.

4. The student must be enrolled in one or more courses at a qualified educational institution.

5. The allowable amount of the credit is reduced where adjusted gross income in 2010 reaches US$50,000.00 phasing to zero when adjusted gross income hits US$60,000.00 if single; US$100,000.00 to US$120,000.00 when married filing jointly. This credit is available to the taxpayer who is a parent **or** the child/student. Implicitly, it could be claimed by the child/student's spouse where they elect to file jointly. This credit is not available to married taxpayers who elect to file separate tax returns. The student/child may not be claimed as a dependent on another's US Federal income tax return and allow the child/student to claim this credit.

Rule Applicable to All of the Credit Provisions

1. The child/student must have a US Social Security Number or its equivalent.

Comments: Given the way these credits work, this could be reason to make gifts of income producing assets to a child/student who is a US person so the child/student has sufficient income and corresponding income tax to utilize these credits. This may be especially important where the parents' income begins to exceed the various phase out limitations with respect to these credits and the deduction for claims of dependency.

The ability to utilize the Lifetime Learning Credit is limited and, ultimately eliminated, as otherwise taxable income increases. Thus, in many cases, a parent may not be able to use the credit. If the child/student who is a US person has income at a more modest level (interest, dividends and capital gains or even some USA sourced earned income), the child/student may be better positioned to use the credit. Given that this is a credit, relative tax rates make no difference.

On the other hand, in order for the child/student to use this credit, the child/student may not be claimed as a dependent on anther's return, including the parent's US Federal return. Unfortunately, the USA income tax regime provides for a statutory deduction for each dependent child and a few others.

But, this statutory deduction associated with claiming a child or others as one's dependent also phases out as income rises. One can voluntarily fail to claim this dependency deduction. So long as the child/student has sufficient income and resulting tax to fully use the credit, the increase in the parent's taxable income and resulting tax by failing to claim the child/student as a dependent is likely to be less than the credit. Indeed, the tax cost of the lost dependency claim might well be zero where the parent's income is sufficient to trigger the phase out of these deductions.

Thus, typically in these fact patterns, the family unit is better off foregoing the dependency claim on the parent's return while electing to utilize the credit on the child/student's return. This is an annual election so it can be changed when facts change.

General comment:

The Coverdell savings program is too small as a practical matter. It is also of necessity tied into the USA "industrial banking system" fraught with fees, low returns and risks. Thus, I would not make use of this with respect to my family.

The second QTP savings program effectively requires my family to make a very early determination that our child will be able to maximize his or her education in an educational institution (sometimes a particular educational institution) located in the USA. This might well not be the best opportunity for any given child once the child reaches the requisite age. Further, given the cost of education in the USA balanced against the likely incremental income that education would afford, it is unlikely that any small tax benefit would offset the USA incremental cost relative to the rest of the world's educational institutions.

The credits are there. I would not allow them to color my family's decisions on the merits of any given educational institution or program which best suits my child's needs, talents and limitations. Further, especially given the relatively small sums of credit involved, the after tax cost of quality education where the credits are available could still well exceed the cost of quality education where the credits are not available.[6] *E.g.*, I will never forget a discussion a couple of years ago with some USA law students saddled with US$250,000.00 in student loans. I doubt these credits made a whit's worth of difference to those young people's current circumstance. In any event, if the credits happened to be available, I would certainly use them but they would not likely influence my original decision.

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[6] We frequently see within the practice and hear from friends and colleagues where the cost of tuition alone in the USA often exceeds US$25,000.00 annually at many institutions of higher learning including at state run facilities.

Interest in Connection With Loans for Education

The USA system has devolved into an ever greater dependence on debt including to support the cost of education. The cost of education in the USA has clearly outpaced any definition of inflation. This is the point of my reference above to current law students graduating with large levels of debt sourced in their educational costs. The US$250,000 number above is real – it relates to several young recent graduates I met at one of the American Bar Association meetings. There is no way that a young person recently graduating from law school could ever reasonably expect their income to be sufficient to repay that loan. This is in no way limited to young lawyers. Indeed, aggregate student loans in the USA is one of the few “consumer loan” categories which continues to grow in this period of recession or, if you prefer, depression. In short, it is big business in the USA lending industries. Further, there were relatively recent changes in the USA Bankruptcy Code which render it very difficult to discharge “student loans” through a bankruptcy process. So, my first observation is to counsel parents and students to think five times before borrowing money for this purpose.

In the origins of my career, nearly all interest expense was deductible from US persons’ otherwise USA taxable income. Commencing perhaps 20 years ago, the deductibility of interest expense began to be curtailed in the USA tax law. Today, even the deduction of interest associated with buying houses is limited. Thus, this ability to deduct some interest associated with loans for educational purposes is somewhat of an exception and may result in a small amount of income tax savings.

1. Interest paid on a qualified educational loan may be deducted in calculating adjusted gross income. In other words, this interest is deductible whether or not one “itemizes deductions” (Schedule A).

    a. A qualified loan is one incurred solely to pay qualified educational expenses.

    b. Qualified educational expenses are the same as those for the Hope Scholarship Credit discussed above. The primary issue is the cost of room and board is **not** a qualified educational expense.

    c. The qualified educational expenses may be incurred on behalf of the taxpayer, the taxpayer’s spouse or a dependent of the taxpayer typically, but not necessarily, a child.

   d. As before, proceeds from scholarships and similar reduce the otherwise qualified educational expense for purposes of these loans.[7]

2. The amount of the deductible interest is limited to US$2,500.00 annually for the first sixty months of the loan once repayment commences.[8]

   a. This US$2,500.00 annual limit is reduced once adjusted gross income reaches US$60,000.00 if one is single; US$120,000.00 if one files jointly with one's spouse. No amount is deductible where one files separately while married.

3. The interest associated with a student loan may not be deducted in any amount where the person otherwise claiming the deduction is claimed as the dependent of another taxpayer.

Deductibility of Actual Educational Expenses

1. Generally, education expenses are not deductible in calculating otherwise taxable income for USA income tax purposes.

2. The exception are educational expenses which either maintain or improve skills required for the taxpayer's current employment, trade or business or are necessary to meet the express requirements of a taxpayer's employer or laws and regulations as a condition for retention of currently established employment, state or other regulatory issues or maintain the current rate of compensation. Illustrations are easiest here:

   a. My education necessary to become a certified public accountant is not deductible from my otherwise taxable income.

   b. The continuing education required to maintain my license or improve my skills as a certified public accountant are deductible.

   c. The cost of my subsequent *juris doctor* degree is not deductible as this education qualifies me for a new profession (law) whether or not I choose to obtain the requisite license to practice law despite the fact that this education certainly enhances my skills as a certified public accountant.

[7] These rules are limiting the deduction of interest expense over a period of five years by sourcing the use of the proceeds from the principal of a loan. Money is fungible. Thus, care needs to be used when administering this.

[8] Generally in the USA system, repayment of a student loan does not commence until the student graduates which is the reason for the rather strange language in this provision.

d. The cost of continuing education necessary to maintain my licenses (should I have both) and maintain or improve either skill set are deductible.

I will forego my usual rant on the unnecessary and intrusive complexity of the USA income and transfer tax regimes. *Res ispa loquitur* ("the thing speaks for itself") with respect to the above discussion.