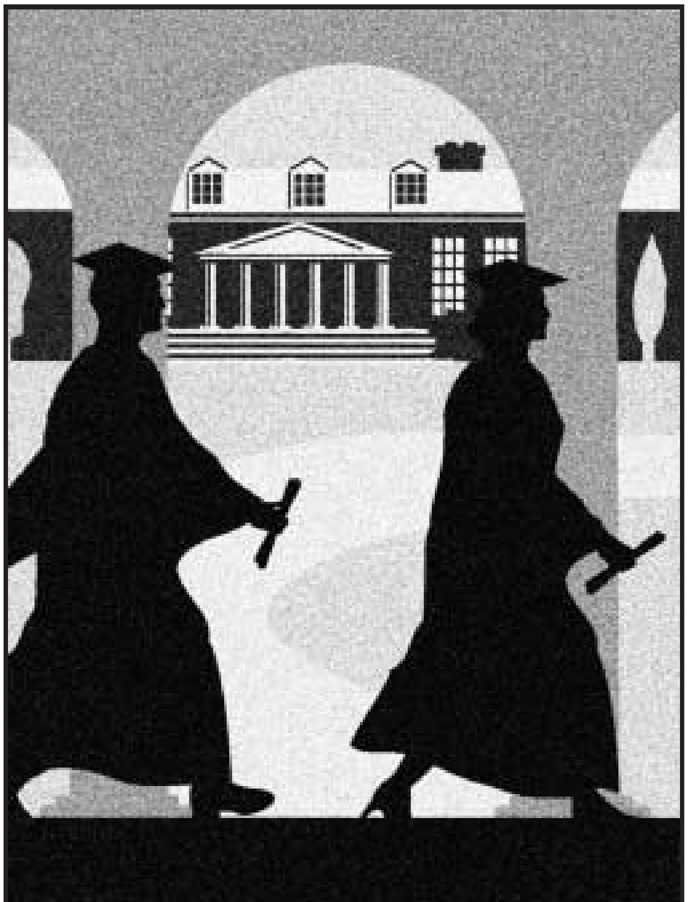
Department of the Treasury
Internal Revenue Service

Publication 970
Cat. No. 25221V

Tax Benefits for Education

For use in preparing

2003 Returns



Get forms and other information faster and easier by:

Internet • www.irs.gov or **FTP** • ftp.irs.gov

FAX • 703–368–9694 (from your fax machine)

Contents

Important Changes for 2003

Hope and lifetime learning credits. If you are married and filing a joint return, the amount of your Hope or lifetime learning credit for 2003 is gradually reduced (phased out) if your modified adjusted gross income (MAGI) is between $83,000 and $103,000. You cannot claim a credit if your MAGI is $103,000 or more. This is an increase from the 2002 limits of $82,000 and $102,000. There was no change in the limits for any other filing status. For more information, see chapters 2 and 3.

Lifetime learning credit. Beginning in 2003, the amount of qualified education expenses you can take into account in figuring your lifetime learning credit increases from $5,000 to $10,000. The credit will equal 20% of these qualified expenses, with the maximum credit being $2,000. See chapter 3 for more information.

Education savings bond program. For 2003, the amount of your interest exclusion will be phased out (gradually reduced) if your filing status is married filing jointly or qualifying widow(er) ***and*** your modified adjusted gross income (MAGI) is between 87,750 and $117,750. You cannot take the deduction if your MAGI is $117,750 or more. For 2002, the limits that applied to you were $86,400 and $116,400.

For all other filing statuses, your interest exclusion is phased out if your MAGI is between $58,500 and $73,500. You cannot take the deduction if your MAGI is $73,500 or more. For 2002, the limits that applied to you were $57,600 and $72,600. For more information, see chapter 10.

Business deduction for work-related education. Beginning in 2003:

- If you drive your car to and from school and qualify to deduct transportation expenses, the amount you can deduct in 2003 is 36 cents per mile, down from 36½ per mile in 2002. See chapter 12 for more information.
- If your adjusted gross income for 2003 is more than $139,500 ($69,750 if you are married filing separately), your itemized deductions may be limited. See chapter 12 and the instructions for line 28 of Schedule A (Form 1040).

Important Changes for 2004

Tuition and fees deduction. Beginning in 2004, the amount of qualified education expenses you can take into account in figuring your tuition and fees deduction increases from $3,000 to $4,000 if your modified adjusted gross income (MAGI) is not more than $65,000 ($130,000 if you are married filing jointly). If your MAGI is larger than $65,000 ($130,000), but is not more than $80,000 ($160,000 if you are married filing jointly), your maximum tuition and fees deduction will be $2,000. No tuition and fees deduction will be allowed if your MAGI is larger than $80,000 ($160,000). The tuition and fees deduction is explained in chapter 6.

Qualified tuition program (QTP). Beginning in 2004, a distribution from a QTP established and maintained by an eligible educational institution (generally private colleges and universities) can be excluded from income if the amount distributed is used to pay qualified education expenses. Qualified tuition programs are discussed in chapter 8.

Important Reminders

Estimated tax. If you have taxable income from any of your education benefits and the payer does not withhold enough income tax, you may need to make estimated tax payments. For more information, see Publication 505, *Tax Withholding and Estimated Tax*.

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 education costs for yourself or, in many cases, another student who is a member of your immediate family. Most benefits apply only to higher education.

Beginning this year, you will find information on all benefits for education in this one publication. Added to this year's publication is information on scholarships, fellowships, and other educational assistance, as well as information on taking a business deduction for work-related education.

Publication 508, *Tax Benefits for Work-Related Education*, and Publication 520, *Scholarships and Fellowships*, will no longer be printed.

What is in this publication. Chapter 1 explains the taxability of various types of educational assistance, including scholarships, fellowships, and tuition reductions.

Two tax credits for which you may be eligible are explained in chapters 2 and 3. These benefits, which reduce the amount of your income tax, are:

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

Nine other types of benefits are explained in chapters 4 through 12. With these benefits, you may be able to:

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

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*, beginning on page 67 of this publication. This general comparison table may guide you in determining which benefits you may be eligible for and which chapters you may want to read.

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

Terminology. In this publication, wherever appropriate, we have tried to use the same or similar terminology when referring to the basic components of each education benefit. Some of the terms used are:

- Qualified education expenses,
- Eligible educational institution, and
- Modified adjusted gross income.

Even though the same term, such as ***qualified education expenses***, is used to label a basic component of many of the education benefits, the same expenses are not necessarily allowed for each benefit. For example, the cost of room and board is a qualified education expense for the qualified tuition program, but not for the education savings bond program.

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

You can e-mail us at ***taxforms@irs.gov**. Please put "Publications Comment" on the subject line.

You can write to us at the following address:

Internal Revenue Service
Individual Forms and Publications Branch
SE:W:CAR:MP:T:I
1111 Constitution Avenue NW
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

- ❏ **463** Travel, Entertainment, Gift, and Car Expenses
- ❏ **525** Taxable and Nontaxable Income
- ❏ **550** Investment Income and Expenses
- ❏ **553** Highlights of 2003 Tax Changes
- ❏ **590** Individual Retirement Arrangements (IRAs)

Form (and Instructions)

- ❏ **1040** U.S. Individual Income Tax Return
- ❏ **1040A** U.S. Individual Income Tax Return
- ❏ **1040EZ** Income Tax Return for Single and Joint Filers With No Dependents
- ❏ **2106** Employee Business Expenses
- ❏ **2106–EZ** Unreimbursed Employee Business Expenses
- ❏ **5329** Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts
- ❏ **8815** Exclusion of Interest From Series EE and I U.S. Savings Bonds Issued After 1989
- ❏ **8863** Education Credits (Hope and Lifetime Learning Credits)
- ❏ **Schedule A (Form 1040)** Itemized Deductions

See chapter 13, *How To Get Tax Help*, for information about getting these publications and forms.

1.

Scholarships, Fellowships, Grants, and Tuition Reductions

Important Reminder

Individual retirement arrangements (IRAs). You can set up and make contributions to an IRA if you receive taxable compensation. Under this rule, a taxable scholarship or fellowship is compensation only if it is shown in box 1 of Form W–2, *Wage and Tax Statement.* For more information about IRAs, see Publication 590.

Introduction

This chapter discusses the taxability of various types of educational assistance you may receive if you are studying, teaching, or researching in the United States. Included in the discussion are:

- Scholarships,
- Fellowships,
- Need-based education grants, such as a Pell Grant, and
- Qualified tuition reductions.

Many of these amounts are tax free if they meet the requirements discussed here.

Special rules apply to U.S. citizens and resident aliens who have received scholarships or fellowships for studying, teaching, or researching abroad. For information about these rules, see Publication 54, *Tax Guide for U.S. Citizens and Resident Aliens Abroad*.

Scholarships and Fellowships

A ***scholarship*** is generally an amount paid or allowed to, or for the benefit of, a student at an educational institution to aid in the pursuit of studies. The student may be either an undergraduate or a graduate.

A ***fellowship*** is generally an amount paid for the benefit of an individual to aid in the pursuit of study or research.

Table 1–1 provides an overview of the tax treatment of scholarships and fellowships.

Table 1–1. **Taxability of Scholarship and Fellowship Payments**

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

IF you use the payment for...	AND you are... A degree candidate	Not a degree candidate	THEN your payment is... Tax free[1]	Taxable
Tuition	X		X	
		X		X
Fees	X		X[2]	
		X		X
Books	X		X[2]	
		X		X
Supplies	X		X[2]	
		X		X
Equipment	X		X[2]	
		X		X
Room	X			X
		X		X
Board	X			X
		X		X
Travel	X			X
		X		X
Teaching	X			X[3]
		X		X
Research services	X			X[3]
	X		X	
Other services	X			X[3]
	X		X	

[1] Payments used for any expenses indicated in this column are tax free only if the terms of the scholarship or fellowship do not prohibit the expense.
[2] If required of all students in the course.
[3] Does not include amounts received under the National Health Service Corps Scholarship Program or the Armed Forces Health Professions Scholarship and Financial Assistance Program.

Tax-Free Scholarships and Fellowships

A scholarship or fellowship is tax free only if:

1) You are a ***candidate for a degree*** at an ***eligible educational institution***, and
2) You use the scholarship or fellowship to pay ***qualified education expenses***.

Candidate for a degree. You are a candidate for a degree if you:

1) Attend a primary or secondary school or are pursuing a degree at a college or university, or

2) Attend an accredited educational institution that is authorized to provide:

   a) A program that is acceptable for full credit toward a bachelor's or higher degree, or

   b) A program of training to prepare students for gainful employment in a recognized occupation.

Eligible educational institution. An eligible educational institution is one that maintains a regular faculty and curriculum and normally has a regularly enrolled body of students in attendance at the place where it carries on its educational activities.

Qualified education expenses. For purposes of tax-free scholarships and fellowships, these are expenses for:

- Tuition and fees required to enroll at or attend an eligible educational institution, and
- Course-related expenses, such as fees, books, supplies, and equipment that are required for the courses at the eligible educational institution. These items must be required of ***all*** students in your course of instruction.

However, in order for these to be qualified education expenses, the terms of the scholarship or fellowship cannot require that it be used for other purposes, such as room and board, or specify that it cannot be used for tuition or course-related expenses.

Expenses that do not qualify. Qualified education expenses do not include the cost of:

- Room and board,
- Travel,
- Research,
- Clerical help, or
- Equipment and other expenses that are not required for enrollment in or attendance at an eligible educational institution.

This is true even if the fee must be paid to the institution as a condition of enrollment or attendance. Scholarship or fellowship amounts used to pay these costs are taxable.

TIP *You can use* Worksheet 1–1 *to figure the tax-free and taxable parts of your scholarship or fellowship.*

Athletic Scholarships

An athletic scholarship is tax free if it meets the requirements discussed above.

Taxable Scholarships and Fellowships

If your scholarship or fellowship does not meet the requirements described earlier, it is taxable. The following amounts received may be taxable.

- Amounts used to pay expenses that do not qualify.
- Payments for services.
- Scholarship prizes.

Each type is discussed below.

Amounts used to pay expenses that do not qualify. A scholarship amount used to pay any expense that does not qualify is taxable, even if the expense is a fee that must be paid to the institution as a condition of enrollment or attendance.

Payment for services. Generally, you must include in income the part of any scholarship, fellowship, or tuition

Worksheet 1–1. **Taxable Scholarship and Fellowship Income**

1.	Enter your scholarship or fellowship income for 2003 . . . . • If you are a degree candidate at an eligible educational institution, go to line 2. • If you are **not** a degree candidate at an eligible educational institution, **stop here**. The entire amount is **taxable**. For information on how to report this amount on your tax return, see *Reporting Scholarships and Fellowships*.	**1.** ______
2.	Enter the amount from line 1 that was for teaching, research, or any other services. (Do not include amounts received for these items under the National Health Service Corps Scholarship Program or the Armed Forces Health Professions Scholarship and Financial Assistance Program.)	**2.** ______
3.	Subtract line 2 from line 1	**3.** ______
4.	Enter the amount from line 3 that your scholarship or fellowship **required** you to use for other than qualified education expenses	**4.** ______
5.	Subtract line 4 from line 3	**5.** ______
6.	Enter the amount from line 5 that was used for qualified education expenses required for study at an eligible educational institution. This amount is the **tax-free part** of your scholarship or fellowship income*	**6.** ______
7.	Subtract line 6 from line 5	**7.** ______
8.	**Taxable part.** Add lines 2, 4, and 7. See *Reporting Scholarships and Fellowships* for how to report this amount on your tax return	**8.** ______

* If you qualify for other education benefits (see chapters 2 through 12), you may have to reduce the amount of education expenses qualifying for a specific benefit by the tax-free amount on this line.

reduction that represents payment for past, present, or future teaching, research, or other services. This applies even if all candidates for a degree must perform the services to receive the degree.

Exceptions. You do not have to include in income the part of any scholarship or fellowship that represents payment for teaching, research, or other services if you receive the amount under:

- The National Health Service Corps Scholarship Program, or
- The Armed Forces Health Professions Scholarship and Financial Assistance Program.

Example 1. You received a scholarship of $2,500. The scholarship was not received under either of the exceptions mentioned above. As a condition for receiving the scholarship, you must serve as a part-time teaching assistant. Of the $2,500 scholarship, $1,000 represents payment for teaching. The provider of your scholarship gives you a Form W–2 showing $1,000 as income. You used all the money for qualified education expenses. Assuming that all other conditions are met, $1,500 of your scholarship is tax free. The $1,000 you received for teaching is taxable.

Example 2. You are a candidate for a degree at a medical school. You receive a scholarship (not under either of the exceptions mentioned above) for your medical education and training. The terms of your scholarship require you to perform future services. A substantial penalty applies if you do not comply. The entire amount of your grant is taxable as payment for services in the year it is received.

Scholarship prizes. If you win a scholarship as a prize in a contest, the scholarship is fully taxable unless you meet the requirements discussed earlier under *Tax-Free Scholarships and Fellowships*.

Reporting Scholarships and Fellowships

Whether you must report your scholarship or fellowship depends on whether you must file a return and whether any part of your scholarship or fellowship is taxable.

If your only income is a completely tax-free scholarship or fellowship, you do not have to file a tax return and no reporting is necessary. If all or part of your scholarship or fellowship is taxable and you are required to file a tax return, report the taxable amount as explained below. You must report the taxable amount whether or not you received a Form W–2. If you receive an incorrect Form W–2, ask the payer for a corrected one.

For information on whether you must file a return, see Publication 501, *Exemptions, Standard Deduction, and Filing Information*, or your income tax form instructions.

How To Report

How you report any taxable scholarship or fellowship income depends on which return you file.

Form 1040EZ. If you file Form 1040EZ, report the taxable amount on line 1. If the taxable amount was not reported on Form W–2, print “SCH” and the taxable amount in the space to the left of line 1.

Form 1040A. If you file Form 1040A, report the taxable amount on line 7. If the taxable amount was not reported on Form W–2, print “SCH” and the taxable amount in the space to the left of line 7.

Form 1040. If you file Form 1040, report the taxable amount on line 7. If the taxable amount was not reported on Form W–2, print “SCH” and the taxable amount on the dotted line next to line 7.

Schedule SE (Form 1040). Amounts you receive under a scholarship as pay for your services as an independent contractor are included in determining net earnings from self-employment. If your net earnings are $400 or more, you will have to pay self-employment tax. Use Schedule SE, *Self-Employment Tax*, to figure this tax.

For more information in determining whether you are an independent contractor or an employee, get Publication 15-A, *Employer’s Supplemental Tax Guide*.

Other Types of Educational Assistance

The following discussions deal with common types of educational assistance other than scholarships and fellowships.

Fulbright Grants

A Fulbright grant is generally treated as a scholarship or fellowship in figuring how much of the grant is tax free.

Pell Grants and Other Title IV Need-Based Education Grants

These need-based grants are treated as scholarships for purposes of figuring their taxability. They are tax free to the extent used for qualified education expenses during the period for which a grant is awarded.

Payment to Service Academy Cadets

An appointment to a United States military academy is not a scholarship or fellowship. Payment you receive as a cadet or midshipman at an armed services academy is pay for personal services. Include this pay in your income in the year you receive it unless one of the exceptions, discussed earlier under *Payment for services*, applies.

Veterans’ Benefits

Payments you receive for education, training, or subsistence under any law administered by the Department of Veterans Affairs (VA) are tax free.

If you qualify for one or more of the education benefits discussed in chapters 2 through 12, you may have to reduce the amount of education expenses qualifying for a specific benefit by part or all of your VA payments. This applies only to the part of your VA payments that is required to be used for education expenses.

Qualified Tuition Reduction

The term “qualified tuition reduction” means a tax-free reduction in tuition provided by an eligible educational institution. Whether a tuition reduction is a qualified tuition reduction, and therefore tax free, depends on whether it is for education below or at the graduate level. The qualified tuition reduction must not represent payment for services.

Education below the graduate level. Qualified tuition reductions for education below the graduate level (including primary and secondary school) are tax free if provided to the following individuals who are treated as employees.

1) A current employee of the eligible educational institution.
2) A former employee who retired or left on disability.
3) A widow or widower of an individual who died while an employee.
4) A widow or widower of a former employee who retired or left on disability.
5) A dependent child or spouse of any person listed in (1) through (4), above.

Child of deceased parents. For purposes of the qualified tuition reduction, a child is a dependent child if the child is under age 25 and both parents have died.

Child of divorced parents. For purposes of the qualified tuition reduction, a dependent child of divorced parents is treated as the dependent of both parents.

Officers, owners, and highly compensated employees. Qualified tuition reductions apply to officers, owners, or highly compensated employees only if benefits are available to employees on a nondiscriminatory basis. This means that the tuition reduction benefits must be available on substantially the same basis to each member of a group of employees. The group must be defined under a reasonable classification set up by the employer. The classification must not discriminate in favor of owners, officers, or highly compensated employees.

Graduate education. Tuition reductions for graduate education are considered “qualified” and are tax free if they are provided by an eligible educational institution to a graduate student who performs teaching or research activities for that institution. All other tuition reductions for graduate education are taxable.

2.

Hope Credit

Important Change for 2003

Income limits increased for married couples filing a joint return. If you are married and filing a joint return, the amount of your Hope credit for 2003 is gradually reduced (phased out) if your modified adjusted gross income (MAGI) is between $83,000 and $103,000. You cannot claim a Hope credit if your MAGI is $103,000 or more. This is an increase from the 2002 limits of $82,000 and $102,000. There was no change in the limits for any other filing status. See *Effect of the Amount of Your Income on the Amount of Your Credit*, later, for more information.

Introduction

There are two tax credits available to help you offset the costs of higher education by reducing the amount of your income tax. They are the Hope credit and the lifetime learning credit, also referred to as education credits. This chapter discusses the Hope credit. The lifetime learning credit is discussed in chapter 3.

This chapter explains:

- Who can claim the Hope credit,
- What expenses qualify for the credit,
- Who is an eligible student,
- Who can claim a dependent's expenses,
- How to figure the credit,
- How to claim the credit, 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 education expenses paid for ***each*** eligible student.

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

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

Can you claim both education 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 2003 tax return, you cannot, for that same child, also claim the lifetime learning credit for 2003.

If you are eligible to claim the Hope credit and you are also eligible to claim the lifetime learning credit for the same student in the same year, you can choose to claim either credit, but not both. For 2003, if the total qualified education expenses for a student are less than $7,500, it will generally be to your benefit to claim the Hope credit.

If you pay qualified education 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.

Differences between the Hope and lifetime learning credits. There are several differences between these two credits. For example, you can claim the Hope credit based on the same student's expenses for no more than 2 years. However, there is no limit on the number of years for which you can claim a lifetime learning credit based on the same student's expenses. The differences between the two credits are summarized in *Table 2–1*.

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

Hope Credit	**Lifetime Learning Credit**
Up to $1,500 credit per **eligible student**	Up to $2,000 credit per **return**
Available **ONLY** until the first 2 years of post-secondary education are completed	Available for all years of postsecondary education and for courses to acquire or improve job skills
Available **ONLY** for 2 years per eligible student	Available for an unlimited number of years
Student must be pursuing an undergraduate degree or other recognized education credential	Student does not need to be pursuing a degree or other recognized education 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 Can Claim the Credit

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

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

Qualified education expenses are defined on the next page under *What Expenses Qualify*. Eligible students are defined later under *Who Is an Eligible Student*. A dependent for whom you claim an exemption is defined later under *Who Can Claim a Dependent's Expenses*.

Who Cannot Claim the Credit

You cannot claim the Hope credit for 2003 if ***any*** of the following apply.

- Your filing status is married filing separately.
- You are listed as a dependent in the *Exemptions* section on another person's tax return (such as your parents'). See *Who Can Claim a Dependent's Expenses*, later.
- Your modified adjusted gross income is $51,000 or more ($103,000 or more in the case of a joint return). Modified adjusted gross income is explained later under *Effect of the Amount of Your Income on the Amount of Your Credit*.
- You (or your spouse) were a nonresident alien for any part of 2003 and the nonresident alien did not elect to be treated as a resident alien for tax purposes. More information on nonresident aliens can be found in Publication 519, *U.S. Tax Guide for Aliens*.
- You claim the lifetime learning credit for the same student in 2003.

What Expenses Qualify

The Hope credit is based on qualified education 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 education expenses paid in 2003 for an ***academic period*** beginning in 2003 or in the first 3 months of 2004.

For example, if you paid $1,500 in December 2003 for qualified tuition for the Spring 2004 semester beginning in January 2004, you may be able to use that $1,500 in figuring your 2003 credit.

Academic period. An academic period includes a semester, trimester, quarter, or other period of study (such as a summer school session) as reasonably determined by an educational institution. In the case of an educational institution that uses credit hours or clock hours and does not have academic terms, each payment period can be treated as an academic period.

Paid with borrowed funds. You can claim a Hope credit for qualified education 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. Treat loan payments sent directly to the educational institution as paid on the date the institution credits the student's account.

Qualified Education Expenses

For purposes of the Hope credit, qualified education expenses are tuition and certain related expenses required for enrollment or attendance at an ***eligible educational institution***.

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

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

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

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

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

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

No Double Benefit Allowed

You cannot do any of the following.

- Deduct higher education expenses on your income tax return (as, for example, a business expense) and also claim a Hope credit based on those same expenses.
- Claim a Hope credit in the same year that you are claiming a tuition and fees deduction for the same student.
- Claim a Hope credit and a lifetime learning credit based on the same qualified education expenses.
- Claim a Hope credit based on the same expenses used to figure the tax-free portion of a distribution from a Coverdell education savings account (ESA) or qualified tuition program (QTP). See *Coordination With Hope and Lifetime Learning Credits* in chapter 7 (Coverdell ESA) and chapter 8 (QTP).

- Claim a credit based on qualified education expenses paid with a tax-free scholarship, grant, or employer-provided educational assistance. See *Adjustments to Qualified Education Expenses*, next.

Adjustments to Qualified Education Expenses

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

Tax-free educational assistance. This includes:

- The tax-free parts of scholarships and fellowships (see chapter 1),
- Pell grants (see chapter 1),
- Employer-provided educational assistance (see chapter 11),
- Veterans' educational assistance (see chapter 1), and
- Any other nontaxable (tax-free) payments (other than gifts or inheritances) received as educational assistance.

Refunds. Qualified education expenses do not include expenses for which you, or someone else who paid qualified education expenses on behalf of a student, receive a refund. (For information on expenses paid by a dependent student or third party, see *Who Can Claim a Dependent's Expenses*, later in this chapter.)

If a refund of expenses paid in 2003 is received before you file your tax return for 2003, simply reduce the amount of the expenses paid by the amount of the refund received. If the refund is received after you file your 2003 tax return, see *When Must the Credit Be Repaid (Recaptured)*, later.

You are considered to receive a refund of expenses when an eligible educational institution refunds loan proceeds to the lender on behalf of the borrower. Depending on when you are considered to receive the refund, follow the above instructions or see *When Must the Credit Be Repaid (Recaptured)*, later.

Amounts that do not reduce qualified education expenses. Do not reduce qualified education expenses by amounts paid with funds the student receives as:

- Payment for services, such as wages,
- A loan,
- A gift,
- An inheritance, or
- A withdrawal from the student's personal savings.

Do not reduce the qualified education expenses by any scholarship or fellowship reported as income on the student's tax return in the following situations.

- The use of the money is restricted to costs of attendance (such as room and board) other than qualified education expenses.
- The use of the money is not restricted and is used to pay education expenses that are not qualified (such as room and board).

Example 1. In 2003, Jackie paid $3,000 for tuition and $5,000 for room and board at University X. The university did not require her to pay any fees in addition to her tuition in order to enroll in or attend classes. To help pay these costs, she was awarded a $2,000 scholarship and a $4,000 student loan.

The terms of the scholarship state that it may be used to pay any of Jackie's college expenses. Because she applied it toward her tuition, the scholarship is tax free. Therefore, for purposes of figuring an education credit (either Hope or lifetime learning), she must first use the $2,000 scholarship to reduce her tuition (her only qualified education expense). The student loan is not tax-free educational assistance, so she does not use it to reduce her qualified expenses. Jackie is treated as having paid $1,000 in qualified education expenses ($3,000 tuition – $2,000 scholarship) in 2003.

Example 2. The facts are the same as in *Example 1*, except that Jackie uses the $2,000 scholarship to pay room and board, and, therefore, reports her entire scholarship as income on her tax return. In this case, the scholarship is allocated to expenses other than qualified education expenses. Jackie is treated as paying the entire $3,000 tuition with other funds and can figure her education credit on the entire $3,000.

Expenses That Do Not Qualify

Qualified education expenses do not include amounts paid for:

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

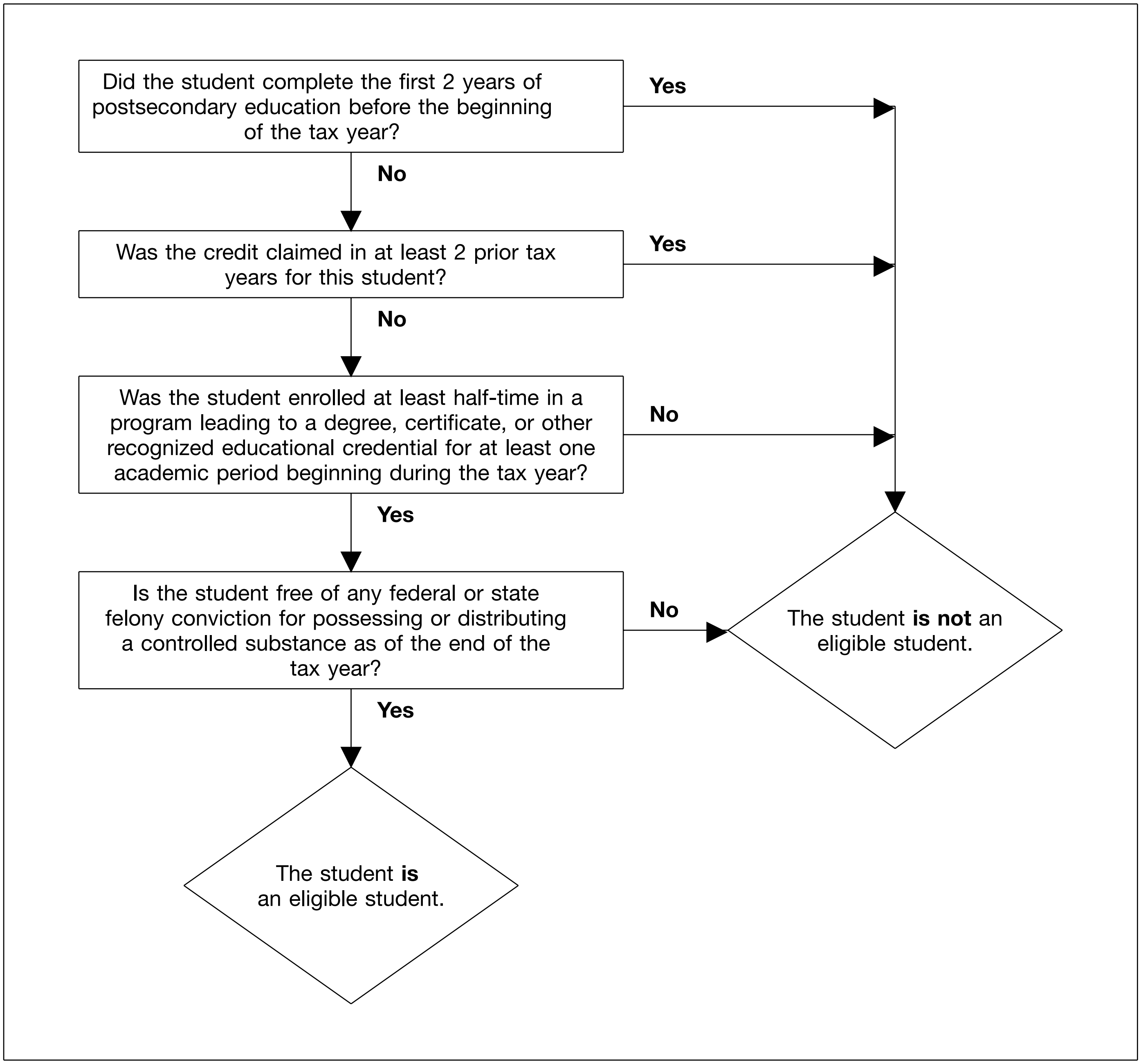
This is true even if the amount must be paid to the institution as a condition of enrollment or attendance.

Sports, games, hobbies, and noncredit courses. Qualified education 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.

Comprehensive or bundled fees. Some eligible educational institutions combine all of their fees for an academic period into one amount. If you do not receive or do not have access to an allocation showing how much you paid for qualified education expenses and how much you paid for personal expenses, such as those listed above, contact the institution. The institution is required to make this allocation and provide you with the amount you paid (or were billed) for qualified education expenses on **Form 1098–T**, *Tuition Statement*. See *Figuring the Credit*, later, for more information about Form 1098–T.

Figure 2–1. **Who Is an Eligible Student?**

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



Who Is an Eligible Student

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

1) Did not have expenses that were used to figure a Hope credit in any 2 earlier tax years.

2) Had not ***completed the first 2 years*** of postsecondary education (generally, the freshman and sophomore years of college) before 2003.

3) For at least one ***academic period*** beginning in 2003, was ***enrolled at least half-time*** in a program leading to a degree, certificate, or other recognized educational credential.

4) Was free of any federal or state felony conviction for possessing or distributing a controlled substance as of the end of 2003.

These requirements are also shown in *Figure 2–1* above.

Completion of first 2 years. A student who was awarded 2 years of academic credit for postsecondary work completed before 2003 has completed the first 2 years of postsecondary education. This student generally would not be an eligible student for purposes of the Hope credit.

Exception. 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.

Example 1. Marty graduated from high school in June 2002. In September, he enrolled in an undergraduate degree program at College U, and attended full time for both the 2002 Fall and 2003 Spring semesters. For the 2003 Fall semester, Marty was enrolled less than half-time. Because Marty was enrolled in an undergraduate degree program on at least a half-time basis for at least one academic period that began during 2002 and at least one academic period that began during 2003, he is an eligible student for tax years 2002 and 2003 (including the 2003 Fall semester when he enrolled at College U on less than a half-time basis).

Example 2. After taking classes at College V on a half-time basis for the 2002 Spring and Fall semesters, Sharon became a full-time student for the 2003 Spring semester. College V classified Sharon as a second-semester sophomore for the 2003 Spring semester and as a first-semester junior for the 2003 Fall semester. Because College V did not classify Sharon as having completed the first two years of postsecondary education as of the beginning of 2003, Sharon is an eligible student for tax year 2003. Therefore, the qualified education expenses paid for the 2003 Spring semester and the 2003 Fall semester are taken into account in calculating any Hope credit for 2003.

Example 3. During the 2002 Fall semester, Luis was a high school student who took classes on a half-time basis at College X. Luis was not enrolled as part of a degree program at College X because College X only admits students to a degree program if they have a high school diploma or equivalent. Because Luis was not enrolled in a degree program at College X during 2002, Luis was **not** an eligible student for tax year 2002.

Example 4. The facts are the same as in *Example 3*. During the 2003 Spring semester, Luis again attended College X but not as part of a degree program. Luis graduated from high school in June 2003. For the 2003 Fall semester, Luis enrolled as a full-time student in College X as part of a degree program, and College X awarded Luis credit for his prior coursework at College X. Because Luis was enrolled in a degree program at College X for the 2003 Fall term on at least a half-time basis, Luis is an eligible student for all of tax year 2003. Therefore, the qualified education expenses paid for classes taken at College X during both the 2003 Spring semester (during which Luis was not enrolled in a degree program) and the 2003 Fall semester are taken into account in computing any Hope credit.

Example 5. Diana graduated from high school in June 2001. In January 2002, Diana enrolled in a one-year postsecondary certificate program on a full-time basis to obtain a certificate as a travel agent. Diana completed the program in December 2002, and was awarded a certificate. In January 2003, she enrolled in a one-year postsecondary certificate program on a full-time basis to obtain a certificate as a computer programmer. Diana is an eligible student for both tax years 2002 and 2003 because she meets the degree requirement, the work load requirement, and the year of study requirement for those years.

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 any of those established by the Department of Education under the Higher Education Act of 1965.

Who Can Claim a Dependent's Expenses

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

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

IF you...	THEN only...
claim an exemption on your tax return for a dependent who is an eligible student	you can claim the Hope credit based on that dependent's expenses. The dependent cannot claim the credit.
do **not** claim an exemption on your tax return for a dependent who is an eligible student (even if entitled to the exemption)	the dependent can claim the Hope credit. You cannot claim the credit based on this dependent'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 (or deemed paid) by your dependent as if you had paid them. Include these expenses when figuring the amount of your Hope credit.

TIP *Qualified education 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 you. If you claim an exemption for a dependent who is an eligible student, only you can include any expenses you paid when figuring the amount of the Hope credit. If neither you nor anyone else claims an exemption for the dependent, only the dependent can include any expenses you paid when figuring the Hope credit.

Expenses paid by others. Someone other than you, your spouse, or your dependent (such as a relative or former spouse) may make a payment directly to an eligible educational institution to pay for an eligible student's qualified education expenses. In this case, the student is treated as receiving the payment from the other person and, in turn, paying the institution. If you claim an exemption on your tax return for the student, you are considered to have paid the expenses.

Example. In 2003, Ms. Allen makes a payment directly to an eligible educational institution for her grandson Todd's qualified education expenses. For purposes of claiming a Hope credit, Todd is treated as receiving the money as a gift from his grandmother and, in turn, paying his qualified education expenses himself.

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

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

Tuition reduction. When an eligible educational institution provides a reduction in tuition to an employee of the institution (or spouse or dependent child of an employee), the amount of the reduction may or may not be taxable. If it is taxable, the employee is treated as receiving a payment of that amount and, in turn, paying it to the educational institution on behalf of the student. For more information on tuition reductions, see *Qualified Tuition Reduction* in chapter 1.

Figuring the Credit

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

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

The maximum amount of Hope credit you can claim in 2003 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 education expenses. However, the credit may be reduced based on your modified adjusted gross income (MAGI). See *Effect of the Amount of Your Income on the Amount of Your Credit*, in the next column.

Example. Jon and Karen Frost are married and file a joint tax return. For 2003, they claim an exemption for their dependent daughter on their tax return. Their MAGI is $70,000. Their daughter is in her sophomore (second) year of studies at the local university. Jon and Karen paid qualified education expenses of $4,300 in 2003.

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 2003. This is 100% of the first $1,000 of qualified education expenses, plus 50% of the next $1,000.

Form 1098–T. To help you figure your Hope credit, you should receive **Form 1098–T**. Generally, an eligible educational institution (such as a college or university) must send Form 1098–T (or acceptable substitute) to each enrolled student by February 2, 2004. An institution may choose to report either payments received (box 1), or amounts billed (box 2), for qualified education expenses. In addition, your Form 1098–T should give you other information for that institution, such as adjustments made for prior years, the amount of scholarships or grants, reimbursements or refunds, and whether you were enrolled at least half-time or were a graduate student.

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

Effect of the Amount of Your Income on the Amount of Your Credit

The amount of your Hope credit is phased out (gradually reduced) if your modified adjusted gross income (MAGI) is between $41,000 and $51,000 ($83,000 and $103,000 if you file a joint return). You cannot claim a Hope credit if your MAGI is $51,000 or more ($103,000 or more if you file a joint return).

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

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

MAGI when using Form 1040. If you file Form 1040, your MAGI is the AGI on line 35 of that form, modified by adding back any:

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

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

Worksheet 2–1. **MAGI for the Hope Credit**

1.	Enter your adjusted gross income (Form 1040, line 35)		**1.** ________
2.	Enter your foreign earned income exclusion and/or housing exclusion (Form 2555, line 43, or Form 2555–EZ, line 18)	**2.** ________	
3.	Enter the amount of income from Puerto Rico that you are excluding . .	**3.** ________	
4.	Enter the amount of income from American Samoa that you are excluding (Form 4563, line 15)	**4.** ________	
5.	Add the amounts on lines 2, 3, and 4		**5.** ________
6.	Add the amounts on lines 1 and 5. This is your **modified adjusted gross income**. Enter this amount on line 10 of your Form 8863		**6.** ________

Phaseout. If your MAGI is within the range of incomes where the credit must be reduced, you will figure your reduced credit using lines 8–14 of Form 8863. The same method is shown in the following example.

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

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

Because the Frosts' MAGI is within the range of incomes where the credit must be reduced, they must multiply their tentative credit ($1,500) by a fraction. The numerator of the fraction is $103,000 (the upper limit for those filing a joint return) minus their MAGI. The denominator is $20,000, the range of incomes for the phaseout ($83,000 to $103,000). The result is the amount of their phased out (reduced) Hope credit ($1,125).

$$\$1{,}500 \times \frac{\$103{,}000 - \$88{,}000}{\$20{,}000} = \$1{,}125$$

Claiming the Credit

You claim the Hope credit by completing Parts I and III of **Form 8863** and submitting it with your Form 1040 or 1040A. Enter the credit on Form 1040, line 47, or on Form 1040A, line 31. A filled-in Form 8863 is shown at the end of this chapter.

When Must the Credit Be Repaid (Recaptured)

If, after you file your 2003 tax return, you or someone else receives 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 2003 as if the assistance or refund was received in 2003. Subtract the amount of the refigured credit from the amount of the credit you claimed. The result is the amount you must repay. You add the repayment (recapture) to your tax liability for the year in which you receive the assistance or refund (see the instructions for your tax return for that year). Your original 2003 tax return does not change.

Illustrated Example

Jim Grant, a single taxpayer, enrolled full-time at a local college to earn a degree in computer science. This is the first year of his postsecondary education. During 2003, he paid $2,600 for his qualified 2003 tuition. He and the college meet all of the requirements for the Hope credit. Jim's MAGI is $32,000. His income tax liability, before credits, is $3,284. He figures his credit of $1,500 as shown on the Form 8863 on the next page.

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

Form **8863**

Department of the Treasury
Internal Revenue Service

Education Credits (Hope and Lifetime Learning Credits)

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

OMB No. 1545-1618
2003
Attachment Sequence No. **50**

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

Caution: *You **cannot** take both an education credit and the tuition and fees deduction (Form 1040, line 26, or Form 1040A, line 19) for the **same student** in the same year.*

Part I Hope Credit. Caution: *You **cannot** take the Hope credit for more than **2** tax years for the **same student.***

1	(a) Student's name (as shown on page 1 of your tax return) First name / Last name	(b) Student's social security number (as shown on page 1 of your tax return)	(c) Qualified expenses (see instructions). **Do not** enter more than $2,000 for each student.	(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	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). If you are taking the lifetime learning credit for another student, go to Part II; otherwise, go to Part III ▶ **3** 1,500

Part II Lifetime Learning Credit

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

4	(a) Student's name (as shown on page 1 of your tax return) First name	Last name	(b) Student's social security number (as shown on page 1 of your tax return)	(c) Qualified expenses (see instructions)

5	Add the amounts on line 4, column (c), and enter the total	5	
6	Enter the **smaller** of line 5 or $10,000	6	
7	Tentative lifetime learning credit. Multiply line 6 by 20% (.20) and go to Part III . . . ▶	7	

Part III Allowable Education Credits

8	Tentative education credits. Add lines 3 and 7			8	1,500
9	Enter: $103,000 if married filing jointly; $51,000 if single, head of household, or qualifying widow(er)	9	51,000		
10	Enter the amount from Form 1040, line 35*, or Form 1040A, line 22 .	10	32,000		
11	Subtract line 10 from line 9. If zero or less, **stop;** you cannot take any education credits	11	19,000		
12	Enter: $20,000 if married filing jointly; $10,000 if single, head of household, or qualifying widow(er)	12	10,000		
13	If line 11 is equal to or more than line 12, enter the amount from line 8 on line 14 and go to line 15. If line 11 is less than line 12, divide line 11 by line 12. Enter the result as a decimal (rounded to at least three places)			13	× .
14	Multiply line 8 by line 13 . . . . ▶			14	1,500
15	Enter the amount from Form 1040, line 43, or Form 1040A, line 28			15	3,284
16	Enter the total, if any, of your credits from Form 1040, lines 44 through 46, or Form 1040A, lines 29 and 30			16	0
17	Subtract line 16 from line 15. If zero or less, **stop;** you cannot take any education credits . . . . ▶			17	3,284
18	**Education credits.** Enter the **smaller** of line 14 or line 17 here and on Form 1040, line 47, or Form 1040A, line 31 . . . . ▶			18	1,500

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

For Paperwork Reduction Act Notice, see page 3. Cat. No. 25379M Form **8863** (2003)

3.

Lifetime Learning Credit

Important Changes for 2003

Income limits increased for married couples filing a joint return. If you are married and filing a joint return, the amount of your lifetime learning credit for 2003 is gradually reduced (phased out) if your modified adjusted gross income (MAGI) is between $83,000 and $103,000. You cannot claim a lifetime learning credit if your MAGI is $103,000 or more. This is an increase from the 2002 limits of $82,000 and $102,000. There was no change in the limits for any other filing status. See *Effect of the Amount of Your Income on the Amount of Your Credit*, later, for more information.

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

Introduction

There are two tax credits available to help you offset the costs of higher education by reducing the amount of your income tax. They are the Hope credit and the lifetime learning credit, also referred to as education credits. This chapter discusses the lifetime learning credit. The Hope credit is discussed in chapter 2.

This chapter explains:

- Who can claim the lifetime learning credit,
- What expenses qualify for the credit,
- Who is an eligible student,
- Who can claim a dependent's expenses,
- How to figure the credit,
- How to claim the credit, 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 $2,000 for qualified education expenses paid for ***all*** students enrolled in eligible educational institutions. There is no limit on the number of years the lifetime learning credit can be claimed for each student.

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

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

Can you claim both education 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 2003 tax return, you cannot, for that same child, also claim the Hope credit for 2003.

If you are eligible to claim the lifetime learning credit and you are also eligible to claim the Hope credit for the same student in the same year, you can choose to claim either credit, but not both. For 2003, if the total qualified education expenses for a student are more than $7,500, it will generally be to your benefit to claim the lifetime learning credit.

If you pay qualified education 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.

Differences between the lifetime learning and Hope credits. There are several differences between these two credits. For example, you can claim the Hope credit based on the same student's expenses for no more than 2 years. However, there is no limit on the number of years for which you can claim a lifetime learning credit based on the same student's expenses. The differences between the two credits are summarized in *Table 3–1*.

Table 3–1. **Comparison of Education Credits**

Lifetime Learning Credit	**Hope Credit**
Up to $2,000 credit per **return**	Up to $1,500 credit per **eligible student**
Available for all years of postsecondary education and for courses to acquire or improve job skills	Available **ONLY** until the first 2 years of post-secondary education are completed
Available for an unlimited number of years	Available **ONLY** for 2 years per eligible student
Student does not need to be pursuing a degree or other recognized education credential	Student must be pursuing an undergraduate degree or other recognized education 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 Can Claim the Credit

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

1) You pay ***qualified education expenses*** of higher education.

2) You pay the education expenses for an ***eligible student***.
3) The eligible student is either yourself, your spouse, or a ***dependent for whom you claim an exemption*** on your tax return.

Qualified education expenses are defined below under *What Expenses Qualify*. Eligible students are defined later under *Who Is an Eligible Student*. A dependent for whom you claim an exemption is defined later under *Who Can Claim a Dependent's Expenses*.

Who Cannot Claim the Credit

You cannot claim the lifetime learning credit for 2003 if ***any*** of the following apply.

- Your filing status is married filing separately.
- You are listed as a dependent in the *Exemptions* section on another person's tax return (such as your parents'). See *Who Can Claim a Dependent's Expenses*, later.
- Your modified adjusted gross income is $51,000 or more ($103,000 or more in the case of a joint return). Modified adjusted gross income is explained later under *Effect of the Amount of Your Income on the Amount of Your Credit*.
- You (or your spouse) were a nonresident alien for any part of 2003 and the nonresident alien did not elect to be treated as a resident alien for tax purposes. More information on nonresident aliens can be found in Publication 519, *U.S. Tax Guide for Aliens*.
- You claim the Hope credit for the same student in 2003.

What Expenses Qualify

The lifetime learning credit is based on qualified education 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 education expenses paid in 2003 for an ***academic period*** beginning in 2003 or in the first 3 months of 2004.

For example, if you paid $1,500 in December 2003 for qualified tuition for the Spring 2004 semester beginning in January 2004, you may be able to use that $1,500 in figuring your 2003 credit.

Academic period. An academic period includes a semester, trimester, quarter, or other period of study (such as a summer school session) as reasonably determined by an educational institution. In the case of an educational institution that uses credit hours or clock hours and does not have academic terms, each payment period can be treated as an academic period.

Paid with borrowed funds. You can claim a lifetime learning credit for qualified education 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. Treat loan payments sent directly to the educational institution as paid on the date the institution credits the student's account.

Qualified Education Expenses

For purposes of the lifetime learning credit, qualified education expenses are tuition and certain related expenses required for enrollment in a course at an ***eligible educational institution***. The course must be either part of a postsecondary degree program or taken by the student to acquire or improve job skills.

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

Related expenses. Student-activity fees and expenses for course-related books, supplies, and equipment are included in qualified education expenses ***only*** if the fees and expenses must be paid ***to the institution*** as a condition of enrollment or attendance. For examples, see *Related expenses* in chapter 2 under *Qualified Education Expenses*.

No Double Benefit Allowed

You cannot do any of the following:

- Deduct higher education expenses on your income tax return (as, for example, a business expense) and also claim a lifetime learning credit based on those same expenses.
- Claim a lifetime learning credit in the same year that you are claiming a tuition and fees deduction for the same student.
- Claim a lifetime learning credit and a Hope credit based on the same qualified education expenses.
- Claim a lifetime learning credit based on the same expenses used to figure the tax-free portion of a distribution from a Coverdell education savings account (ESA) or qualified tuition program (QTP). See *Coordination With Hope and Lifetime Learning Credits* in chapter 7 (Coverdell ESA) and chapter 8 (QTP).
- Claim a credit based on qualified education expenses paid with a tax-free scholarship, grant, or employer-provided educational assistance. See *Adjustments to Qualified Education Expenses*, next.

Adjustments to Qualified Education Expenses

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

Tax-free educational assistance. This includes:

- The tax-free part of scholarships and fellowships (see chapter 1),

- Pell grants (see chapter 1),
- Employer-provided educational assistance (see chapter 11),
- Veterans' educational assistance (see chapter 1), and
- Any other nontaxable (tax-free) payments (other than gifts or inheritances) received as educational assistance.

Refunds. Qualified education expenses do not include expenses for which you, or someone else who paid qualified education expenses on behalf of a student, receive a refund. (For information on expenses paid by a dependent student or third party, see *Who Can Claim a Dependent's Expenses*, later in this chapter.)

If a refund of expenses paid in 2003 is received before you file your tax return for 2003, simply reduce the amount of the expenses paid by the amount of the refund received. If the refund is received after you file your 2003 tax return, see *When Must the Credit Be Repaid (Recaptured)*, later.

You are considered to receive a refund of expenses when an eligible educational institution refunds loan proceeds to the lender on behalf of the borrower. Depending on when you are considered to receive the refund, follow the above instructions or see *When Must the Credit Be Repaid (Recaptured)*, later.

Amounts that do not reduce qualified education expenses. Do not reduce qualified education expenses by amounts paid with funds the student receives as:

- Payment for services, such as wages,
- A loan,
- A gift,
- An inheritance, or
- A withdrawal from the student's personal savings.

Do not reduce the qualified education expenses by any scholarship or fellowship reported as income on the student's tax return in the following situations.

- The use of the money is restricted to costs of attendance (such as room and board) other than qualified education expenses.
- The use of the money is not restricted and is used to pay education expenses that are not qualified (such as room and board).

For examples, see *Adjustments to Qualified Education Expenses* in chapter 2.

Expenses That Do Not Qualify

Qualified education expenses do not include amounts paid for:

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

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

Sports, games, hobbies, and noncredit courses. Qualified education expenses generally do not include expenses that relate to any course of instruction or other education that involves sports, games or hobbies, or any noncredit course. However, if the course of instruction or other education is part of the student's degree program or is taken by the student to acquire or improve job skills, these expenses can qualify.

Comprehensive or bundled fees. Some eligible educational institutions combine all of their fees for an academic period into one amount. If you do not receive or do not have access to an allocation showing how much you paid for qualified education expenses and how much you paid for personal expenses, such as those listed above, contact the institution. The institution is required to make this allocation and provide you with the amount you paid (or were billed) for qualified education expenses on **Form 1098–T**, *Tuition Statement*. See *Figuring the Credit*, later, for more information about Form 1098–T.

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*** (as defined on page 17).

Who Can Claim a Dependent's Expenses

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

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

IF you...	**THEN only...**
claim an exemption on your tax return for a dependent who is an eligible student	you can claim the lifetime learning credit based on that dependent's expenses. The dependent cannot claim the credit.
do **not** claim an exemption on your tax return for a dependent who is an eligible student (even if entitled to the exemption)	the dependent can claim the lifetime learning credit. You cannot claim the credit based on this dependent'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 (or deemed paid) by your dependent as if you had paid them. Include these expenses when figuring the amount of your lifetime learning credit.

TIP *Qualified education 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 you. If you claim an exemption for a dependent who is an eligible student, only you can include any expenses you paid when figuring the amount of the lifetime learning credit. If neither you nor anyone else claims an exemption for the dependent, the dependent can include any expenses you paid when figuring the lifetime learning credit.

Expenses paid by others. Someone other than you, your spouse, or your dependent (such as a relative or former spouse) may make a payment directly to an eligible educational institution to pay for an eligible student's qualified education expenses. In this case, the student is treated as receiving the payment from the other person and, in turn, paying the institution. If you claim an exemption on your tax return for the student, you are considered to have paid the expenses.

Example. In 2003, Ms. Allen makes a payment directly to an eligible educational institution for her grandson Todd's qualified education expenses. For purposes of claiming a lifetime learning credit, Todd is treated as receiving the money as a gift from his grandmother and, in turn, paying his qualified education expenses himself.

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

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

Tuition reduction. When an eligible educational institution provides a reduction in tuition to an employee of the institution (or spouse or dependent child of an employee), the amount of the reduction may or may not be taxable. If it is taxable, the employee is treated as receiving a payment of that amount and, in turn, paying it to the educational institution on behalf of the student. For more information on tuition reductions, see *Qualified Tuition Reduction* in chapter 1.

Figuring the Credit

The amount of the lifetime learning credit is 20% of the first $10,000 of qualified education expenses you paid for all eligible students. The maximum amount of lifetime learning credit you can claim for 2003 is $2,000 (20% × $10,000). However, that amount may be reduced based on your modified adjusted gross income (MAGI). See *Effect of the Amount of Your Income on the Amount of Your Credit*, in the next column.

Example. Bruce and Toni Harper are married and file a joint tax return. For 2003, their MAGI is $75,000. Toni is attending a local college (an eligible educational institution) to earn credits toward a degree in nursing. She already has a bachelor's degree in history and wants to become a nurse. In August 2003, Toni paid $6,000 of qualified education expenses for her Fall 2003 semester. Bruce and Toni can claim a $1,200 (20% × $6,000) lifetime learning credit on their 2003 joint tax return.

Form 1098–T. To help you figure your lifetime learning credit, you should receive **Form 1098–T**. Generally, an eligible educational institution (such as a college or university) must send Form 1098–T (or acceptable substitute) to each enrolled student by February 2, 2004. An institution may choose to report either payments received (box 1), or amounts billed (box 2), for qualified education expenses. In addition, your Form 1098–T should give you other information for that institution, such as adjustments made for prior years, the amount of scholarships or grants, reimbursements or refunds, and whether you were enrolled at least half-time or were a graduate student.

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

Effect of the Amount of Your Income on the Amount of Your Credit

The amount of your lifetime learning credit is phased out (gradually reduced) if your modified adjusted gross income (MAGI) is between $41,000 and $51,000 ($83,000 and $103,000 if you file a joint return). You cannot claim a lifetime learning credit if your MAGI is $51,000 or more ($103,000 or more if you file a joint return).

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

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

MAGI when using Form 1040. If you file Form 1040, your MAGI is the AGI on line 35 of that form, modified by adding back any:

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

You can use *Worksheet 3–1* (on the next page) to figure your MAGI.

Worksheet 3–1. **MAGI for the Lifetime Learning Credit**

1. Enter your adjusted gross income (Form 1040, line 35)		**1.** ________
2. Enter your foreign earned income exclusion and/or housing exclusion (Form 2555, line 43, or Form 2555–EZ, line 18)	**2.** ________	
3. Enter the amount of income from Puerto Rico that you are excluding . . .	**3.** ________	
4. Enter the amount of income from American Samoa that you are excluding (Form 4563, line 15)	**4.** ________	
5. Add the amounts on lines 2, 3, and 4		**5.** ________
6. Add the amounts on lines 1 and 5. This is your **modified adjusted gross income**. Enter this amount on line 10 of your Form 8863		**6.** ________

Phaseout. If your MAGI is within the range of incomes where the credit must be reduced, you will figure your reduced credit using lines 8–14 of Form 8863. The same method is shown in the following example.

Example. The information is the same as in the Harper example (previous page), except that Bruce and Toni have a MAGI of $95,000.

They figure the tentative lifetime learning credit (20% of the first $10,000 of qualified education expenses they paid for all eligible students). As shown in the previous example, the result is a $1,200 (20% x $6,000) tentative credit.

Because the Harper's MAGI is within the range of incomes where the credit must be reduced, they must multiply their tentative credit ($1,200) by a fraction. The numerator of the fraction is $103,000 (the upper limit for those filing a joint return) minus their MAGI. The denominator is $20,000, the range of incomes for the phaseout ($83,000 to $103,000). The result is the amount of their phased out (reduced) lifetime learning credit ($480).

$$\$1,200 \times \frac{\$103,000 - \$95,000}{\$20,000} = \$480$$

Claiming the Credit

You claim the lifetime learning credit by completing Parts II and III of **Form 8863** and submitting it with your Form 1040 or 1040A. Enter the credit on Form 1040, line 47, or Form 1040A, line 31. A filled-in Form 8863 is shown at the end of this chapter.

When Must the Credit Be Repaid (Recaptured)

If, after you file your 2003 tax return, you or someone else receives 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 2003 as if the assistance or refund was received in 2003. Subtract the amount of the refigured credit from the amount of the credit you claimed. The result is the amount you must repay. You add the repayment (recapture) to your tax liability for the year in which you receive the assistance or refund (see the instructions for your tax return for that year). Your original 2003 tax return does not change.

Illustrated Example

Judy Green, a single taxpayer, is taking courses at a community college to be recertified to teach in public schools. Her MAGI is $22,000. Her tax, before credits, is $1,784. In July 2003 she pays $700 for the Summer 2003 semester; in August 2003 she pays $1,900 for the Fall 2003 semester; and in December 2003 she pays another $1,900 for the Spring semester beginning January 2004. 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 2003 when figuring her credit for her 2003 tax return. She figures her credit as shown on the filled-in Form 8863 on the next page.

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

Form **8863**

Department of the Treasury
Internal Revenue Service

Education Credits (Hope and Lifetime Learning Credits)

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

OMB No. 1545-1618
2003
Attachment Sequence No. 50

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

Caution: *You* ***cannot*** *take both an education credit and the tuition and fees deduction (Form 1040, line 26, or Form 1040A, line 19) for the* ***same student*** *in the same year.*

Part I **Hope Credit. Caution:** *You* ***cannot*** *take the Hope credit for more than* ***2*** *tax years for the* ***same student.***

1	**(a)** Student's name (as shown on page 1 of your tax return) First name / Last name	**(b)** Student's social security number (as shown on page 1 of your tax return)	**(c)** Qualified expenses (see instructions). **Do not** enter more than $2,000 for each student.	**(d)** Enter the **smaller** of the amount in column (c) or $1,000	**(e)** Subtract column (d) from column (c)	**(f)** Enter one-half of the amount in column (e)
2 Add the amounts in columns (d) and (f)			**2**			

3 Tentative Hope credit. Add the amounts on line 2, columns (d) and (f). If you are taking the lifetime learning credit for another student, go to Part II; otherwise, go to Part III ► **3**

Part II **Lifetime Learning Credit**

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

(a) Student's name (as shown on page 1 of your tax return) First name	Last name	**(b)** Student's social security number (as shown on page 1 of your tax return)	**(c)** Qualified expenses (see instructions)
Judy	Green	000 00 7777	4,500

5	Add the amounts on line 4, column (c), and enter the total	**5**	4,500
6	Enter the **smaller** of line 5 or $10,000	**6**	4,500
7	Tentative lifetime learning credit. Multiply line 6 by 20% (.20) and go to Part III . . ►	**7**	900

Part III **Allowable Education Credits**

8	Tentative education credits. Add lines 3 and 7			**8**	900
9	Enter: $103,000 if married filing jointly; $51,000 if single, head of household, or qualifying widow(er)	**9**	51,000		
10	Enter the amount from Form 1040, line 35*, or Form 1040A, line 22 .	**10**	22,000		
11	Subtract line 10 from line 9. If zero or less, **stop;** you cannot take any education credits	**11**	29,000		
12	Enter: $20,000 if married filing jointly; $10,000 if single, head of household, or qualifying widow(er)	**12**	10,000		
13	If line 11 is equal to or more than line 12, enter the amount from line 8 on line 14 and go to line 15. If line 11 is less than line 12, divide line 11 by line 12. Enter the result as a decimal (rounded to at least three places)			**13**	× .
14	Multiply line 8 by line 13 . . . . ►			**14**	900
15	Enter the amount from Form 1040, line 43, or Form 1040A, line 28			**15**	1,784
16	Enter the total, if any, of your credits from Form 1040, lines 44 through 46, or Form 1040A, lines 29 and 30			**16**	0
17	Subtract line 16 from line 15. If zero or less, **stop;** you cannot take any education credits . . . . ►			**17**	1,784
18	**Education credits.** Enter the **smaller** of line 14 or line 17 here and on Form 1040, line 47, or Form 1040A, line 31 . . . . ►			**18**	900

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

For Paperwork Reduction Act Notice, see page 3. Cat. No. 25379M Form **8863** (2003)

4.

Student Loan Interest Deduction

Introduction

Generally, personal interest you pay, other than certain mortgage interest, is not deductible on your tax return. However, there is a special deduction allowed for paying interest on a student loan (also known as an education loan). This deduction can reduce the amount of your income subject to tax by up to $2,500 in 2003.

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

This chapter explains:

- What type of loan interest you can deduct,
- Whether you can claim the deduction,
- What expenses you must have paid with the student loan,
- Who is an eligible student,
- Who can claim a dependent's expenses,
- How to figure the deduction, and
- How to claim the deduction.

Table 4–1 summarizes the features of the student loan interest deduction.

Table 4–1. **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 reduce your income subject to tax by up to $2,500.
Loan qualifications	Your student loan: • must have been taken out solely to pay qualified education expenses, and • cannot be from a related person or made under a qualified employer plan.
Student qualifications	The student must be: • you, your spouse, or your dependent, and • enrolled at least half-time in a degree program.
Time limit on deduction	You can deduct interest paid during the remaining period of your student loan.
Phaseout	The amount of your deduction depends on your income level.

Student Loan Interest Defined

Student loan interest is interest you paid during the year on a ***qualified student loan***. It includes both required and voluntary interest payments.

Qualified Student Loan

This is a loan you took out solely to pay ***qualified education expenses*** (defined later) that were:

1) For you, your spouse, or a person who was ***your dependent*** when you took out the loan,
2) Paid or incurred within a ***reasonable period of time*** before or after you took out the loan, and
3) For education provided during an ***academic period*** for an ***eligible student***.

Loans from the following sources are ***not*** qualified student loans.

- A ***related person***.
- A ***qualified employer plan***.

Your dependent. Generally, your 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.

You can find more information about dependents in Publication 501, *Exemptions, Standard Deduction, and Filing Information*.

Reasonable period of time. Qualified education expenses are treated as paid or incurred within a reasonable period of time before or after you take out the loan if they are paid with the proceeds of student loans that are part of a federal postsecondary education loan program.

Even if 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 specific ***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. In the case of an educational institution that uses credit hours or clock hours and does not have academic terms, each payment period can be treated as an academic period.

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

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

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

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.

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.

Qualified Education Expenses

For purposes of the student loan interest deduction, these expenses are the total costs of attending an ***eligible educational institution***, including graduate school. They include amounts paid for the following items.

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

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

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

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.*

Adjustments to Qualified Education Expenses

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

- Employer-provided educational assistance. See chapter 11.
- Tax-free distributions from a Coverdell education savings account (ESA). See chapter 7.
- Tax-free distributions from a qualified tuition program (QTP). See chapter 8.
- U.S. savings bond interest that you exclude from income because it is used to pay qualified education expenses. See chapter 10.
- The tax-free part of scholarships and fellowships. See chapter 1.
- Veterans' educational assistance. See chapter 1.
- Any other nontaxable (tax-free) payments (other than gifts or inheritances) received as educational assistance.

Include As Interest

In addition to simple interest on the loan, if all other requirements are met, the items discussed below can be student loan interest.

Loan origination fees. These are the costs (other than fees for services) of getting the loan.

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

Interest on revolving lines of credit. This interest, which includes interest on credit card debt, is student loan interest if the borrower uses the line of credit (credit card) ***only*** to pay qualified education expenses. See *Qualified Education Expenses*, earlier.

Interest on refinanced student loans. This includes interest on both:

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

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

Example. The payments on Roger's student loan were scheduled to begin in June 2002, 6 months after he graduated from college. He began making payments as required. In September 2003, Roger enrolled in graduate school on a full-time basis. He applied for and was granted deferment of his loan payments while in graduate school. Wanting to pay down his student loan as much as possible, he made loan payments in October and November, 2003. Even though these were voluntary (not required) payments, Roger can deduct the interest paid in October and November.

When Must Interest Be Paid

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

If you started making required payments before 2002, and your payments continued into 2002 or later, see *Table 4–2* and the example that follows. These illustrate how your student loan interest deduction may have changed.

Table 4–2. **Changes in Allowable Deduction Period for Student Loan Interest**

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

Example. You took out a qualified student loan in 1994. Beginning October 1, 1996, you made a payment on the loan every month, as required. In September 2002, you received a small inheritance that allowed you to make an extra payment on your loan during October, November, December, and January. You made your final loan payment in August 2003. No student loan interest deduction was allowed before 1998. The following interest payments would qualify for deduction.

1996: None
1997: None

1998: 12 payments (1st year deduction allowed)
1999: 12 payments
2000: 12 payments
2001: 9 payments (60-month period ended in September)

2002: 15 payments (law changed — 12 required + 3 voluntary payments)
2003: 9 payments (8 required + 1 voluntary)

Do Not Include As Interest

You cannot claim a student loan interest deduction for interest on a loan if, under the terms of the loan, you are not legally obligated to make interest payments.

Can You Claim the Deduction

Generally, you can claim the deduction if ***all*** three 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 qualified student loan.

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

Example. During 2003, Josh paid $600 interest on his qualified student loan. Only he is legally obligated to make the payments. No one claims an exemption for Josh for 2003. Assuming all other requirements are met, Josh can deduct the $600 of interest he paid on his 2003 Form 1040 or 1040A.

No Double Benefit Allowed

You cannot deduct as interest on a student loan any amount that is an allowable deduction under any other provision of the tax law (for example, as home mortgage interest).

Who Can Claim a Dependent's Expenses

You can deduct interest paid on a student loan for your dependent only if ***you***:

1) Are legally obligated to make the interest payments,
2) Actually made the payments during the tax year, and
3) Claim an exemption for your dependent on your tax return.

You are not considered to have made student loan interest payments actually made by your dependent, regardless of whether your dependent is legally liable for the loan. Also, payments made by anyone other than your dependent are not considered made by your dependent.

Example. During 2003, Jo paid $1,100 interest on her qualified student loan. Only she is legally obligated to make the payments. Jo's parents claimed an exemption for her on their 2003 tax return. In this case, neither Jo nor her parents may deduct the student loan interest Jo paid in 2003.

Figuring the Deduction

Your student loan interest deduction for 2003 is generally the smaller of:

1) $2,500, or
2) The interest you paid in 2003.

However, the amount determined above may be gradually reduced (phased out) or eliminated based on your filing status and modified adjusted gross income (MAGI) as explained below. You can use *Worksheet 4–1* (see next page) to figure both your MAGI and your deduction.

Form 1098–E. To help you figure your student loan interest deduction, you should receive **Form 1098–E**, *Student Loan Interest Statement*. Generally, an institution (such as a bank or governmental agency) that received interest payments of $600 or more during 2003 on one or more qualified student loans must send Form 1098–E (or acceptable substitute) to each borrower by February 2, 2004.

The lender may ask for a completed **Form W–9S**, *Request for Student's or Borrower's Taxpayer Identification Number and Certification*, or similar statement to obtain the borrower's name, address, and taxpayer identification number. The form may also be used by the borrower to certify that the student loan was incurred solely to pay for qualified education expenses.

Effect of the Amount of Your Income on the Amount of Your Deduction

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

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

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

MAGI when using Form 1040. If you file Form 1040, your MAGI is the AGI on line 35 of that form figured without taking into account any amount on line 25 (Student loan interest deduction) or line 26 (Tuition and fees deduction), and modified by adding back any:

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

Table 4–3 shows how the amount of your MAGI can affect your student loan interest deduction.

Table 4–3. **Effect of MAGI on Student Loan Interest Deduction**

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

Phaseout. If your MAGI is within the range of incomes where the credit must be reduced, you must figure your reduced deduction. To figure the phaseout, multiply your interest deduction (before the phaseout) by a fraction. The numerator is your MAGI minus $50,000 ($100,000 in the case of a joint return). The denominator is $15,000 ($30,000 in the case of a joint return). Subtract the result from your deduction (before the phaseout). This result is the amount you can deduct.

Example 1. During 2003 you paid $800 interest on a qualified student loan. Your 2003 MAGI is $125,000 and you are filing a joint return. You must reduce your deduction by $667, figured as follows.

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

Your reduced student loan interest deduction is $133 ($800 – $667).

Example 2. The facts are the same as in *Example 1* except that you paid $2,750 interest. Your maximum deduction for 2003 is $2,500. You must reduce your maximum deduction by $2,083, figured as follows.

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

In this example, your reduced student loan interest deduction is $417 ($2,500 – $2,083).

Which Worksheet To Use

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 4–1* below.

Claiming the Deduction

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

Worksheet 4–1. **Student Loan Interest Deduction Worksheet** *(Keep for Your Records)*

*Use this worksheet instead of the worksheet in the Form 1040 instructions if you are filing **Form 2555, 2555–EZ,** or **4563,** or you are excluding income from sources within Puerto Rico. You must complete **Form 1040,** lines 7 through 24 and lines 27 through 32a, plus any amount to be entered on the dotted line next to line 33, before using this worksheet.*

1. Enter the total interest you paid in 2003 on qualified student loans. **Do not enter more than $2,500** . . . **1.** ______

2. Enter your total income from Form 1040, line 22 . . . **2.** ______

3. Enter the total of amounts from Form 1040, lines 23 and 24 . . . **3.** ______

4. Enter the total of amounts from Form 1040, lines 27 through 32a, plus any amount you entered on the dotted line next to line 33 . . . **4.** ______

5. Add the amounts on lines 3 and 4 . . . **5.** ______

6. Subtract the amount on line 5 from the amount on line 2 . . . **6.** ______

7. Enter any foreign earned income exclusion and/or housing exclusion (Form 2555, line 43, or Form 2555–EZ, line 18) . . . **7.** ______

8. Enter any housing deduction (Form 2555, line 48) . . . **8.** ______

9. Enter the amount of income from Puerto Rico that you are excluding **9.** ______

10. Enter the amount of income from American Samoa that you are excluding (Form 4563, line 15) . . . **10.** ______

11. Add the amounts on lines 6 through 10. This is your modified adjusted gross income . . . **11.** ______

12. Enter the amount shown below for your filing status . . . **12.** ______

- Single, head of household, or qualifying widow(er) — $50,000
- Married filing jointly — $100,000

13. Is the amount on line 11 more than the amount on line 12?

❑ **No.** Skip line 14, enter -0- on line 15, and go to line 16.

❑ **Yes.** Subtract line 12 from line 11 . . . **13.** ______

14. Divide line 13 by $15,000 ($30,000 if married filing jointly). Enter the result as a decimal (rounded to at least three places). If the result is 1.000 or more, enter 1.000 . . . **14.** ____.____

15. Multiply line 1 by line 14 . . . **15.** ______

16. **Student loan interest deduction.** Subtract line 15 from line 1. Enter the result here and on Form 1040, line 25. **Do not** include this amount in figuring any other deduction on your return (such as on Schedule A, C, E, etc.) . . . **16.** ______

5. Cancellation of Student Loan

Introduction

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 chapter describes the requirements for tax-free treatment of canceled student loans.

Qualifying Loans

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 ***eligible 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 eligible 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 its students to serve in occupations with unmet needs or in areas with unmet needs 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.*

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.

Eligible educational institution. This is an educational institution that maintains a regular faculty and curriculum and normally has a regularly enrolled body of students in attendance at the place where it carries on its educational activities.

Refinanced Loan

If you refinanced a student loan with another loan from an eligible educational institution or a tax-exempt organization, that loan may also be considered as made by a qualified lender. It is considered made by a qualified lender if it meets the requirements of (3)(b) under *Qualified lenders* in the previous column.

6. Tuition and Fees Deduction

Important Change for 2004

Maximum deduction increases to $4,000. Beginning in 2004, the amount of qualified education expenses you may take into account in figuring your tuition and fees deduction increases from $3,000 to $4,000 if your modified adjusted gross income (MAGI) is not more than $65,000 ($130,000 if you are married filing jointly). If your MAGI is larger than $65,000 ($130,000), but is not more than $80,000 ($160,000 if you are married filing jointly), your maximum tuition and fees deduction will be $2,000. No tuition and fees deduction will be allowed if your MAGI is larger than $80,000 ($160,000).

Introduction

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

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

This deduction is taken as an adjustment to income. This means you can claim this deduction even if you do not itemize deductions on Schedule A (Form 1040). This deduction may be beneficial to you if you cannot take either the Hope or lifetime learning credit because your income is too high.

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

Table 6–1 summarizes the features of the tuition and fees deduction.

Can You Claim the Deduction

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

Who Can Claim the Deduction

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

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

Qualified education expenses are defined below under *What Expenses Qualify*. Eligible students are defined later under *Who Is an Eligible Student*. A dependent for whom you claim an exemption is defined later under *Who Can Claim a Dependent's Expenses*.

Who Cannot Claim the Deduction

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

- Your filing status is married filing separately.
- Another person can claim an exemption for you as a dependent on his or her tax return. You cannot take the deduction even if the other person does not actually claim that exemption.
- Your modified adjusted gross income (MAGI) is more than $65,000 ($130,000 if filing a joint return).
- You were a nonresident alien for any part of the year and did not elect to be treated as a resident alien for tax purposes. More information on nonresident aliens can be found in Publication 519, *U.S. Tax Guide for Aliens*.
- You or anyone else claims a Hope or lifetime learning credit in 2003 with respect to expenses of the student for whom the qualified education expenses were paid.

Table 6–1. **Tuition and Fees Deduction at a Glance**

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

Question	Answer
What is the maximum benefit?	You can reduce your income subject to tax by up to $3,000.
Where is the deduction taken?	As an adjustment to income on Form 1040 or 1040A.
For whom must the expenses be paid?	A student enrolled in an eligible educational institution who is either: • you, • your spouse, or • your dependent for whom you claim an exemption.
What tuition and fees are deductible?	Tuition and fees required for enrollment or attendance at an eligible postsecondary educational institution, but not including personal, living, or family expenses, such as room and board.

What Expenses Qualify

The tuition and fees deduction is based on qualified education expenses you pay for yourself, your spouse, or a dependent for whom you claim an exemption on your tax return. Generally, the deduction is allowed for qualified education expenses paid in 2003 in connection with enrollment at an institution of higher education during 2003 or for an ***academic period*** beginning in 2003 or in the first 3 months of 2004.

For example, if you paid $1,500 in December 2003 for qualified tuition for the Spring 2004 semester beginning in January 2004, you may be able to use that $1,500 in figuring your 2003 deduction.

Academic period. An academic period includes a semester, trimester, quarter, or other period of study (such as a summer school session) as reasonably determined by an educational institution. In the case of an educational institution that uses credit hours or clock hours and does not have academic terms, each payment period can be treated as an academic period.

Paid with borrowed funds. You can claim a tuition and fees deduction for qualified education expenses paid with the proceeds of a loan. You use the expenses to figure the deduction for the year in which the expenses are paid, not the year in which the loan is repaid. Treat loan payments sent directly to the educational institution as paid on the date the institution credits the student's account.

Qualified Education Expenses

For purposes of the tuition and fees deduction, qualified education expenses are tuition and certain related expenses required for enrollment or attendance at an ***eligible educational institution***.

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

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

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

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

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

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

No Double Benefit Allowed

You cannot do any of the following.

- Deduct qualified education expenses you deduct under any other provision of the law, for example, as a business expense.
- Deduct qualified education expenses for a student on your income tax return if you or anyone else claims a Hope or lifetime learning credit for that same student in the same year.
- Deduct qualified education expenses that have been used to figure the tax-free portion of a distribution from a Coverdell education savings account (ESA) or a qualified tuition program (QTP). For a QTP, this applies only to the amount of tax-free earnings that were distributed, not to the recovery of contributions to the program. See *Figuring the Taxable Portion of a Distribution* in chapter 7 (Coverdell ESA) and in chapter 8 (QTP).
- Deduct qualified education expenses that have been paid with tax-free interest on U.S. savings bonds (Form 8815). See *Figuring the Tax-Free Amount* in chapter 10.
- Deduct qualified education expenses that have been paid with tax-free scholarship, grant, or employer-provided educational assistance. See the following section on *Adjustments to Qualified Education Expenses*.

Adjustments to Qualified Education Expenses

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

Tax-free educational assistance. This includes:

- The tax-free part of scholarships and fellowships (see chapter 1),
- Pell grants (see chapter 1),

- Employer-provided educational assistance (see chapter 11),
- Veterans' educational assistance (see chapter 1), and
- Any other nontaxable (tax-free) payments (other than gifts or inheritances) received as educational assistance.

Refunds. Qualified education expenses do not include expenses for which you, or someone else who paid qualified education expenses on behalf of a student, receive a refund. (For information on expenses paid by a dependent student or third party, see *Who Can Claim a Dependent's Expenses*, in the next column.)

If a refund of expenses paid in 2003 is received before you file your tax return for 2003, simply reduce the amount of the expenses paid by the amount of the refund received. If the refund is received after you file your 2003 tax return, see *When Must the Deduction Be Repaid (Recaptured)*, at the end of this chapter.

You are considered to receive a refund of expenses when an eligible educational institution refunds loan proceeds to the lender on behalf of the borrower. Follow the above instructions according to when you are considered to receive the refund.

Amounts that do not reduce qualified education expenses. Do not reduce qualified education expenses by amounts paid with funds the student receives as:

- Payment for services, such as wages,
- A loan,
- A gift,
- An inheritance, or
- A withdrawal from the student's personal savings.

Do not reduce the qualified education expenses by any scholarship or fellowship reported as income on the student's tax return in the following situations.

- The use of the money is restricted to costs of attendance (such as room and board) other than qualified education expenses.
- The use of the money is not restricted and is used to pay education expenses that are not qualified (such as room and board).

Example 1. In 2003, Jackie paid $3,000 for tuition and $5,000 for room and board at University X. The university did not require her to pay any fees in addition to her tuition in order to enroll in or attend classes. To help pay these costs, she was awarded a $2,000 scholarship and a $4,000 student loan.

The terms of the scholarship state that it may be used to pay any of Jackie's college expenses. Because she applied it toward her tuition, the scholarship is tax free. Therefore, for purposes of figuring the tuition and fees deduction, she must first use the $2,000 scholarship to reduce her tuition (her only qualified education expense). The student loan is not tax-free educational assistance, so she does not use it to reduce her qualified expenses. Jackie is treated as having paid $1,000 in qualified education expenses ($3,000 tuition – $2,000 scholarship) in 2003.

Example 2. The facts are the same as in *Example 1*, except that Jackie uses the $2,000 scholarship to pay room and board and, therefore, reports her entire scholarship as income on her tax return. In this case, the scholarship is allocated to expenses other than qualified education expenses. Jackie is treated as paying the entire $3,000 tuition with other funds, and can figure her tuition and fees deduction on the entire $3,000.

Expenses That Do Not Qualify

Qualified education expenses do not include amounts paid for:

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

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

Sports, games, hobbies, and noncredit courses. Qualified education 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.

Comprehensive or bundled fees. Some eligible educational institutions combine all of their fees for an academic period into one amount. If you do not receive or do not have access to an allocation showing how much you paid for qualified education expenses and how much you paid for personal expenses, such as those listed above, contact the institution. The institution is required to make this allocation and provide you with the amount you paid (or were billed) for qualified education expenses on **Form 1098–T**, *Tuition Statement*. See *Figuring the Deduction*, later, for more information about Form 1098–T.

Who Is an Eligible Student

For purposes of the tuition and fees deduction, an eligible student is a student who is enrolled in one or more courses at an ***eligible educational institution*** (as defined on page 29). The student must have either a high school diploma or a General Educational Development (GED) credential.

Who Can Claim a Dependent's Expenses

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

1) Have paid the expenses, and

2) Claim an exemption for the student as a dependent.

For you to be able to deduct qualified education expenses for your dependent, you ***must*** claim an exemption for that individual. You do this by listing your dependent's name and other required information on line 6c, Form 1040 (or Form 1040A).

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

Expenses paid by dependent. If your dependent pays qualified education expenses and you can claim an exemption for your dependent on your tax return, no one can take a tuition and fees deduction for those expenses. Neither you nor your dependent can deduct the expenses. For purposes of the tuition and fees deduction, you are not treated as paying any expenses actually paid by a dependent for whom you or anyone other than the dependent can claim an exemption. This rule applies even if you do not claim an exemption for your dependent on your tax return.

Expenses paid by you. If you claim an exemption for a dependent who is an eligible student, only you can include any expenses you paid when figuring your tuition and fees deduction. If neither you nor anyone else can claim an exemption for a dependent who is an eligible student, the dependent can include any expenses you paid when figuring the amount of his or her tuition and fees deduction.

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

Expenses paid by others. Someone other than you, your spouse, or your dependent (such as a relative or former spouse) may make a payment directly to an eligible educational institution to pay for an eligible student's qualified education expenses. In this case, the student is treated as receiving the payment from the other person and, in turn, paying the institution. If you claim, or can claim, an exemption on your tax return for the student, you are ***not*** considered to have paid the expenses and you cannot deduct them. If the student is not a dependent, only the student can deduct payments made directly to the institution for his or her expenses. If the student is your dependent, no one can deduct the payments.

Example. In 2003, Ms. Baker makes a payment directly to an eligible educational institution for her grandson Dan's qualified education expenses. For purposes of deducting tuition and fees, Dan is treated as receiving the money as a gift from his grandmother and, in turn, paying his own qualified education expenses.

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

Tuition reduction. When an eligible educational institution provides a reduction in tuition to an employee of the institution (or spouse or dependent child of an employee), the amount of the reduction may or may not be taxable. If it is taxable, the employee is treated as receiving a payment of that amount and, in turn, paying it to the educational institution on behalf of the student. For more information on tuition reductions, see *Qualified Tuition Reduction* in chapter 1.

Figuring the Deduction

The maximum deduction you can claim in 2003 is $3,000. However, the amount of your modified adjusted gross income (MAGI) determines whether any deduction is allowed. See *Effect of the Amount of Your Income on the Amount of Your Deduction*, on the next page.

Form 1098–T. To help you figure your tuition and fees deduction, you should receive **Form 1098–T**. Generally, an eligible educational institution (such as a college or university) must send Form 1098–T (or acceptable substitute) to each enrolled student by February 2, 2004. An institution may choose to report either payments received (box 1), or amounts billed (box 2), for qualified education expenses. In addition, your Form 1098–T should give you other information for that institution, such as adjustments made for prior years, the amount of scholarships or grants, reimbursements or refunds, and whether you were enrolled at least half-time or were a graduate student.

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

Effect of the Amount of Your Income on the Amount of Your Deduction

If your modified adjusted gross income (MAGI) is more than $65,000 ($130,000 if you file a joint return), you ***cannot*** claim a tuition and fees deduction.

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

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

MAGI when using Form 1040. If you file Form 1040, your MAGI is the AGI on line 35 of that form, figured without taking into account any amount on line 26 (Tuition and fees deduction) and modified by adding back any:

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

You can use *Worksheet 6–1* to figure your MAGI.

Claiming the Deduction

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

When Must the Deduction Be Repaid (Recaptured)

If, after you file your 2003 tax return, you or someone else receives tax-free educational assistance for, or a refund of, an expense you used to figure a tuition and fees deduction on that return, you may have to repay all or part of the deduction. This applies to assistance and refunds received by the individual claiming the deduction, and, in the case of a student who claims the deduction, refunds received by anyone else who paid such expenses for the student.

You must include the assistance or refund in income in the year received up to the amount by which the deduction of the refunded amount reduced your tax in 2003. Refigure the deduction for 2003 as if you received the assistance or refund in 2003. Then refigure your 2003 tax liability. Subtract the refigured tax from your original (or previously adjusted) 2003 tax. The result is the amount you must repay. Add the repayment to income for the year you receive the assistance or refund (see the instructions for your tax return for that year). Your 2003 tax return does not change.

Worksheet 6–1. **MAGI for the Tuition and Fees Deduction** *(Keep for your records)*

Use this worksheet instead of the worksheet in the Form 1040 instructions if you are filing ***Form 2555, 2555–EZ,*** or ***4563****, or you are excluding income from sources within Puerto Rico. Before using this worksheet, you must complete* ***Form 1040****, lines 7 through 25 and lines 27 through 32a and figure any amount to be entered on the dotted line next to line 33.*

1. Enter the amount from Form 1040, line 22 . . . . **1.** ______

2. Enter the total from Form 1040, lines 23 through 25 . . . . **2.** ______

3. Enter the total from Form 1040, lines 27 through 32a, plus any amount entered on the dotted line next to line 33 . . . . **3.** ______

4. Add the amounts on lines 2 and 3 . . . . **4.** ______

5. Subtract the amount on line 4 from the amount on line 1 . . . . **5.** ______

6. Enter your foreign earned income exclusion and/or housing exclusion (Form 2555, line 43, or Form 2555–EZ, line 18) . . . . **6.** ______

7. Enter your foreign housing deduction (Form 2555, line 48) . . . . **7.** ______

8. Enter the amount of income from Puerto Rico you are excluding . . . . . **8.** ______

9. Enter the amount of income from American Samoa you are excluding (Form 4563, line 15) . . . . **9.** ______

10. Add the amounts on lines 5 through 9. This is your **modified adjusted gross income** . . . . . . **10.** ______

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

7.

Coverdell Education Savings Account (ESA)

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).

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

TIP *This benefit applies not only to higher education expenses, but also to elementary and secondary education expenses.*

What is the tax benefit of the Coverdell ESA. Contributions to a Coverdell ESA are not deductible, but amounts deposited in the account grow tax free until distributed.

If, for a year, distributions 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 distributions. See *Tax-Free Distributions,* later.

Table 7–1 summarizes the main features of the Coverdell ESA.

What Is a Coverdell ESA

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

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

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

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

1) The trustee or custodian must be a bank or an entity approved by the IRS.
2) The document must provide that the trustee or custodian can only accept a contribution that meets all of the following conditions.
   a) Is in cash.
   b) Is made before the beneficiary reaches age 18, unless the beneficiary is a special needs beneficiary.
   c) Would not result in total contributions for the year (not including rollover contributions) being more than $2,000.
3) Money in the account cannot be invested in life insurance contracts.
4) Money in the account cannot be combined with other property except in a common trust fund or common investment fund.
5) The balance in the account generally must be distributed within 30 days after the earlier of the following events.
   a) The beneficiary reaches age 30, unless the beneficiary is a special needs beneficiary.
   b) The beneficiary's death.

CAUTION *As of this printing, regulations defining a* **special needs beneficiary** *have not been released. If available, the definition will be included in Publication 553,* Highlights of 2003 Tax Changes*, which will be issued in early 2004.*

Qualified Education Expenses

Generally, these are expenses required for the enrollment or attendance of the ***designated beneficiary*** at an ***eligible educational institution***. For purposes of Coverdell ESAs, the expenses can be either ***qualified higher education expenses*** or ***qualified elementary and secondary education expenses***. Eligible educational institutions can include both postsecondary schools and elementary and secondary schools.

Table 7–1. **Coverdell ESA at a Glance**

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

Question	Answer
What is a **Coverdell ESA**?	A savings account that is set up to pay the **qualified education expenses** of a **designated beneficiary**.
Where can it be established?	It can be opened in the United States at any bank or other IRS-approved entity that offers Coverdell ESAs.
Who can have a Coverdell ESA?	Any beneficiary who is under age 18 or is a special needs beneficiary.
Who can contribute to a Coverdell ESA?	Generally, any individual (including the beneficiary) whose **modified adjusted gross income** for the year is less than $110,000 ($220,000 in the case of a joint return).
Are distributions tax free?	Yes, if the distributions are not more than the beneficiary's **adjusted qualified education expenses** for the year.

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

Eligible Educational Institution

For purposes of Coverdell ESAs, an eligible educational institution can be either an ***eligible postsecondary school*** or an ***eligible elementary or secondary school***.

Eligible postsecondary school. 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.

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

Qualified Higher Education Expenses

These are expenses related to enrollment or attendance at an eligible postsecondary school. As shown in the following list, to be qualified, some of the expenses must be required by the school and some must be incurred by students who are enrolled at least half-time. Contributions to qualified tuition programs can be qualified education expenses (see the last item in the following list).

1) The following expenses must be required for enrollment or attendance of a designated beneficiary at an eligible postsecondary school.

   a) Tuition and fees.

   b) Books, supplies, and equipment.

2) Expenses for special needs services needed by a special needs beneficiary must be incurred in connection with enrollment or attendance at an eligible postsecondary school. (See *Caution* in the next column.)

3) Expenses for room and board must be incurred by students who are enrolled at least half-time (defined in the next column).

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

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

   b) The actual amount charged if the student is residing in housing owned or operated by the school.

4) Any contribution to a qualified tuition program (QTP) must be on behalf of the designated beneficiary of the Coverdell ESA. (See chapter 8, *Qualified Tuition Program (QTP)*.)

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

Qualified Elementary and Secondary Education Expenses

These are expenses related to enrollment or attendance at an eligible elementary or secondary school. As shown in the following list, to be qualified, some of the expenses must be required or provided by the school. There are special rules for computer-related expenses.

1) The following expenses must be incurred by a designated beneficiary in connection with enrollment or attendance at an eligible elementary or secondary school.

   a) Tuition and fees.

   b) Books, supplies, and equipment.

   c) Academic tutoring.

   d) Special needs services for a special needs beneficiary. (See *Caution* below.)

2) The following expenses must be required or provided by an eligible elementary or secondary school in connection with attendance or enrollment at the school.

   a) Room and board.

   b) Uniforms.

   c) Transportation.

   d) Supplementary items and services (including extended day programs).

3) The purchase of computer technology, equipment, or Internet access and related services is a qualified elementary and secondary education expense if it is to be used by the beneficiary and the beneficiary's family during any of the years the beneficiary is in elementary or secondary school. (This does not include expenses for computer software designed for sports, games, or hobbies unless the software is predominantly educational in nature.)

CAUTION

As of this printing, regulations defining a **special needs beneficiary** *have not been released. If available, the definition will be included in Publication 553,* Highlights of 2003 Tax Changes*, which will be issued in early 2004.*

Contributions

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

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

Contributions must meet all of the following requirements.

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

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

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

Table 7–2 summarizes many of the features of contributing to a Coverdell ESA.

Contribution Limits

There are two yearly limits:

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

Limit for each designated beneficiary. For 2003, the total of all contributions to all Coverdell ESAs set up for the benefit of any one designated beneficiary cannot be more than $2,000. This includes contributions (other than rollovers) to ***all*** the beneficiary's Coverdell ESAs from all sources. Rollovers are discussed under *Rollovers and Other Transfers*, later.

Example. When Maria Luna was born in 2002, three separate Coverdell ESAs were set up for her, one by her parents, one by her grandfather, and one by her aunt. In 2003, the total of all contributions to Maria's three Coverdell ESAs cannot be more than $2,000. For example, if her grandfather contributed $2,000 to one of her Coverdell ESAs, no one else could contribute to any of her three accounts. Or, if her parents contributed $1,000 and her aunt $600, her grandfather or someone else could contribute no more than $400. These contributions could be put into any of Maria's Coverdell ESA accounts.

Limit for each contributor. Generally, you can contribute up to $2,000 for each designated beneficiary for 2003. This is the most you can contribute for the benefit of any one beneficiary for the year, regardless of the number of Coverdell ESAs set up for the beneficiary.

Example. The facts are the same as in the previous example except that Maria Luna's older brother, Edgar, also has a Coverdell ESA. If their grandfather contributed $2,000 to Maria's Coverdell ESA in 2003, he could also contribute $2,000 to Edgar's Coverdell ESA.

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

Table 7–2. **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 distributed.
What is the annual **contribution limit** per designated beneficiary?	$2,000 for each designated beneficiary.
What if more than one Coverdell ESA has been opened for the same designated beneficiary?	The annual contribution limit is $2,000 for each beneficiary, no matter how many Coverdell ESAs are set up for that beneficiary.
What if more than one individual makes contributions for the same designated beneficiary?	The annual contribution limit is $2,000 per beneficiary, no matter how many individuals contribute.
Can contributions other than cash be made to a Coverdell ESA?	No.
When must contributions stop?	No contributions can be made to a beneficiary's Coverdell ESA after he or she reaches age 18, unless the beneficiary is a special needs beneficiary.

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

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

MAGI when using Form 1040. If you file Form 1040, your MAGI is the AGI on line 35 of that form, modified by adding back any:

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

You can use *Worksheet 7–1*, on the next page, to figure your MAGI.

Worksheet 7–1. **MAGI for a Coverdell ESA**

1. Enter your adjusted gross income (Form 1040, line 35)		**1.** ________
2. Enter your foreign earned income exclusion and/or housing exclusion (Form 2555, line 43, or Form 2555–EZ, line 18)	**2.** ________	
3. Enter the amount of income from Puerto Rico that you are excluding	**3.** ________	
4. Enter the amount of income from American Samoa that you are excluding (Form 4563, line 15)	**4.** ________	
5. Add the amounts on lines 2, 3, and 4		**5.** ________
6. Add the amounts on lines 1 and 5. This is your **modified adjusted gross income**		**6.** ________

Figuring the limit. To figure the limit on the amount you can contribute for each designated beneficiary, multiply $2,000 by a fraction. The numerator (top number) is your MAGI minus $95,000 ($190,000 if filing a joint return). The denominator (bottom number) is $15,000 ($30,000 if filing a joint return). Subtract the result from $2,000. This is the amount you can contribute for each beneficiary. You can use *Worksheet 7–2* to figure the limit on your contributions.

Worksheet 7–2. **Coverdell ESA Contribution Limit**

1. Maximum contribution	**1.** $ 2,000
2. Enter your modified adjusted gross income (MAGI) for purposes of figuring the contribution limit to a Coverdell ESA (see definition or *Worksheet 7–1* earlier)	**2.** ________
3. Enter $190,000 if married filing jointly; $95,000 for all other filers	**3.** ________
4. Subtract line 3 from line 2. If zero or less, enter -0- on line 4, skip lines 5 through 7, and enter $2,000 on line 8	**4.** ________
5. Enter $30,000 if married filing jointly; $15,000 for all other filers **Note.** *If the amount on line 4 is greater than or equal to the amount on line 5, **stop here**. You are not allowed to contribute to a Coverdell ESA for 2003.*	**5.** ________
6. Divide line 4 by line 5 and enter the result as a decimal (rounded to at least 3 places)	**6.** .
7. Multiply line 1 by line 6	**7.** ________
8. Subtract line 7 from line 1	**8.** ________

Note: *The total Coverdell ESA contributions from all sources for the designated beneficiary during the tax year may not exceed $2,000.*

Example. Paul, who is single, had MAGI of $96,500 for 2003. Paul can contribute up to $1,800 in 2003 for each beneficiary, as shown in the illustrated *Worksheet 7–2*.

Worksheet 7–2. **Coverdell ESA Contribution Limit — Illustrated**

1. Maximum contribution	**1.** $ 2,000
2. Enter your modified adjusted gross income (MAGI) for purposes of figuring the contribution limit to a Coverdell ESA (see definition or *Worksheet 7–1* earlier)	**2.** 96,500
3. Enter $190,000 if married filing jointly; $95,000 for all other filers	**3.** 95,000
4. Subtract line 3 from line 2. If zero or less, enter -0- on line 4, skip lines 5 through 7, and enter $2,000 on line 8	**4.** 1,500
5. Enter $30,000 if married filing jointly; $15,000 for all other filers **Note.** *If the amount on line 4 is greater than or equal to the amount on line 5, **stop here**. You are not allowed to contribute to a Coverdell ESA for 2003.*	**5.** 15,000
6. Divide line 4 by line 5 and enter the result as a decimal (rounded to at least 3 places)	**6.** .100
7. Multiply line 1 by line 6	**7.** 200
8. Subtract line 7 from line 1	**8.** 1,800

Note: *The total Coverdell ESA contributions from all sources for the designated beneficiary during the tax year may not exceed $2,000.*

Additional Tax on Excess Contributions

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

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

Exceptions. The excise tax does not apply if excess contributions made during 2003 (and any earnings on them) are distributed before the first day of the sixth month of the following tax year (June 1, 2004, for a calendar year taxpayer).

However, you must include the distributed earnings in gross income for the year in which the excess contribution was made. You should receive **Form 1099–Q**, *Payments From Qualified Education Programs (Under Sections 529 and 530)*, from each institution from which excess contributions were distributed. Box 2 of that form will show the amount of earnings on your excess contributions. Enter the amount of earnings on line 21 of Form 1040. For more information, see *Taxable Distributions*, later.

The excise tax does not apply to any rollover contribution.

Example. In 2002, Greta's parents and grandparents contributed a total of $2,300 to Greta's Coverdell ESA, an excess contribution of $300. Because Greta did not withdraw the excess before June 1, 2003, she had to pay an additional tax of $18 (6% × $300) when she filed her 2002 tax return.

In 2003, excess contributions to the same account totaled $500, but Greta withdrew $250 to use for qualified education expenses. Using the steps shown under *Additional Tax on Excess Contributions*, Greta figures the excess contribution in her account at the end of 2003 as follows.

	(1)	$500 excess paid in 2003	
+	(2)	$300 excess contributions at end of 2002	
–	(2a)	$250 distribution during 2003	
		$550 excess at end of 2003	× 6% = $33

If Greta limits 2004 contributions to $1,450 ($2,000 maximum allowed – $550 excess contributions from 2003), she will not owe any additional tax in 2004 for excess contributions.

Figuring the additional tax. You figure this excise tax in Part V, **Form 5329**, *Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts*. Report the additional tax on line 57, Form 1040.

Rollovers and Other Transfers

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

Rollovers

Any amount distributed 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 (including the beneficiary's spouse) 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 distribution.

Members of the beneficiary's family. For these purposes, the beneficiary's family includes the beneficiary's spouse and the following other relatives of the beneficiary.

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

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

Changing the Designated Beneficiary

The designated beneficiary can be changed to a member of the beneficiary's family (defined above). 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.

Distributions

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

See *Table 7–3*, on the next page, for highlights.

Adjusted qualified education expenses. To determine if total distributions for the year are more than the amount of qualified education expenses, reduce total qualified education expenses by any ***tax-free educational assistance***. Tax-free educational assistance includes:

- The tax-free part of scholarships and fellowships (see chapter 1),
- Veterans' educational assistance (see chapter 1),
- Pell grants (see chapter 1),
- Employer-provided educational assistance (see chapter 11), and
- Any other nontaxable (tax-free) payments (other than gifts or inheritances) received as educational assistance.

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

Table 7–3. **Coverdell ESA Distributions 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 distribution 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 distribution is not more than the designated beneficiary's adjusted qualified education expenses.
After the designated beneficiary completes his or her education at an **eligible educational institution**, can amounts remaining in the Coverdell ESA be distributed?	Yes. Amounts ***must*** be distributed when the designated beneficiary reaches age 30, unless he or she is a special needs beneficiary. Also, certain transfers to **members of the beneficiary's family** are permitted.
Does the designated beneficiary need to be enrolled for a minimum number of courses to take a tax-free distribution?	No.

Tax-Free Distributions

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

Taxable Distributions

A portion of the distributions is generally taxable to the beneficiary if the distributions are more than the beneficiary's adjusted qualified education expenses for the year.

Excess distribution. This is the part of the total distribution that is more than the beneficiary's adjusted qualified education expenses for the year.

Earnings and basis. You will receive a **Form 1099–Q**, for each of the Coverdell ESAs from which money was distributed in 2003. The amount of your gross distribution will be shown in box 1. For 2003, instead of dividing the gross distribution between your earnings (box 2) and your basis (already-taxed amount) (box 3), the payer or trustee may report the fair market value (account balance) of the Coverdell ESA as of December 31, 2003. This will be shown in the blank box below boxes 5 and 6.

Figuring the Taxable Portion of a Distribution

The taxable portion is the amount of the excess distribution that represents earnings that have accumulated tax free in the account. Figure the taxable portion for 2003 as shown in the following steps.

1) Multiply the amount distributed by a fraction. The numerator is the basis (contributions not previously distributed) at the end of 2002 plus total contributions for 2003 and the denominator is the value (balance) of the account at the end of 2003 plus the amount distributed during 2003.
2) Subtract the amount figured in (1) from the total amount distributed during 2003. This is the amount of earnings included in the distribution(s).
3) Multiply the amount of earnings figured in (2) by a fraction. The numerator is the adjusted qualified education expenses paid during 2003 and the denominator is the total amount distributed during 2003.
4) Subtract the amount figured in (3) from the amount figured in (2). This is the amount the beneficiary must include in income.

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

Example. You received an $850 distribution from your Coverdell ESA, to which $1,500 had been contributed before 2003. There were no contributions in 2003. This is your first distribution from the account, so your basis in the account on December 31, 2002, was $1,500. The value (balance) of your account on December 31, 2003, was $950. You had $700 of adjusted qualified education expenses (AQEE) for the year. Using the steps above, figure the taxable portion of your distribution as follows.

1) $\$850 \text{ (distribution)} \times \frac{\$1{,}500 \text{ basis} + \$0 \text{ contributions}}{\$950 \text{ value} + \$850 \text{ distribution}}$

   = $708 (basis portion of distribution)

2) $850 (distribution) – $708 (basis portion of distribution)

   = $142 (earnings included in distribution)

3) $\$142 \text{ (earnings)} \times \frac{\$700 \text{ AQEE}}{\$850 \text{ distribution}}$

   = $117 (tax-free earnings)

4) $142 (earnings included in distribution) – $117 (tax-free earnings)

   = $25 (taxable earnings)

You must include $25 in income as distributed earnings not used for qualified education expenses. Report this amount on Form 1040, line 21, listing the type and amount of income on the dotted line.

Worksheet 7–3, later in this chapter, can help you figure your adjusted qualified education expenses, how much of your distribution must be included in income, and the remaining basis in your Coverdell ESAs.

Coordination With Hope and Lifetime Learning Credits

The Hope or lifetime learning credit can be claimed in the same year the beneficiary takes a tax-free distribution from a Coverdell ESA, as long as the same expenses are not used for both benefits. This means the beneficiary must reduce qualified higher education expenses by tax-free educational assistance, and then further reduce them by any expenses taken into account in determining a Hope or lifetime learning credit.

Example. Derek Green had $4,200 of qualified higher education expenses for 2003, his first year in college. He paid his college expenses from the following sources.

Partial tuition scholarship (tax free)	$1,500
Coverdell ESA distribution	1,000
Gift from parents	500
Earnings from part-time job	1,200

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

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

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

Since the adjusted qualified higher education expenses ($700) are less than the Coverdell ESA distribution, part of the distribution will be taxable. The balance in Derek's account was $1,800 on December 31, 2003. Prior to 2003, $2,200 had been contributed to this account. Contributions for 2003 totaled $300. Using the four steps outlined earlier, Derek figures the taxable portion of his distribution as shown below.

1) $\$1{,}000 \text{ (distribution)} \times \dfrac{\$2{,}200 \text{ basis} + \$300 \text{ contributions}}{\$1{,}800 \text{ value} + \$1{,}000 \text{ distribution}}$

   = $893 (basis portion of distribution)

2) $1,000 (distribution) – $893 (basis portion of distribution)

   = $107 (earnings included in distribution)

3) $\$107 \text{ (earnings)} \times \dfrac{\$700 \text{ AQHEE}}{\$1{,}000 \text{ distribution}}$

   = $75 (tax-free earnings)

4) $107 (earnings included in distribution) – $75 (tax-free earnings)

   = $32 (taxable earnings)

Derek must include $32 in income. This is the amount of distributed earnings not used for adjusted qualified higher education expenses.

Coordination With Qualified Tuition Program (QTP) Distributions

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

Example 1. In 2003, Beatrice graduated from high school and began her first semester of college. That year, she had $1,000 of qualified elementary and secondary education expenses (QESEE) for high school and $3,000 of qualified higher education expenses (QHEE) for college. To pay these expenses, Beatrice withdrew $800 from her Coverdell ESA and $4,200 from her QTP. No one claimed Beatrice as a dependent, nor was she eligible for an education credit. She did not receive any tax-free educational assistance in 2003. Beatrice must allocate her total qualified education expenses between the two distributions.

1) Beatrice knows that tax-free treatment will be available if she applies her $800 Coverdell ESA distribution toward her $1,000 of qualified education expenses for high school. The qualified expenses are greater than the distribution, making the $800 Coverdell ESA distribution tax free.
2) Next, Beatrice matches her $4,200 QTP distribution to her $3,000 of QHEE, and finds she has an excess QTP distribution of $1,200 ($4,200 QTP – $3,000 QHEE). She cannot use the extra $200 of high school expenses (from (1) above) against the QTP distribution because those expenses do not qualify a QTP for tax-free treatment.
3) Finally, Beatrice figures the taxable and tax-free portions of her QTP distribution based on her $3,000 of QHEE. (See *Figuring the Taxable Portion of a Distribution*, in chapter 8, for more information.)

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

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

   $$\underset{\text{QHEE}}{\$3{,}000} \times \frac{\$800 \text{ ESA distribution}}{\$4{,}000 \text{ total distribution}} = \underset{\text{QHEE (ESA)}}{\$600}$$

   $$\underset{\text{QHEE}}{\$3{,}000} \times \frac{\$3{,}200 \text{ QTP distribution}}{\$4{,}000 \text{ total distribution}} = \underset{\text{QHEE (QTP)}}{\$2{,}400}$$

3) Beatrice then figures the taxable part of her:
   - Coverdell ESA distribution based on qualified education expenses of $1,600 ($1,000 QESEE + $600 QHEE). See *Figuring the Taxable Portion of a Distribution*, earlier in this chapter.
   - QTP distribution based on her $2,400 of QHEE (see *Figuring the Taxable Portion of a Distribution*, in chapter 8).

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

Losses on Coverdell ESA Investments

If you have a loss on your investment in a Coverdell ESA, you may be able to take the loss on your income tax return. You can take the loss only when all amounts from that account have been distributed and the total distributions are less than your unrecovered basis. Your basis is the total amount of contributions to that Coverdell ESA. You claim the loss as a miscellaneous itemized deduction on line 22 of Schedule A (Form 1040), subject to the 2%-of-adjusted-gross-income limit. For more information and examples of the calculation, see *Losses on QTP Investments* in chapter 8 under *Figuring the Taxable Portion of a Distribution*.

Additional Tax on Taxable Distributions

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

Exceptions. The 10% additional tax does not apply to distributions:

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) Included in income because the designated beneficiary received:
   a) A tax-free scholarship or fellowship (see chapter 1),
   b) Veterans' educational assistance (see chapter 1),
   c) Employer-provided educational assistance (see chapter 11), or
   d) Any other nontaxable (tax-free) payments (other than gifts or inheritances) received as educational assistance.
4) Made on account of the attendance of the designated beneficiary at a U.S. military academy (such as West Point). This exception applies only to the extent that the amount of the distribution does not exceed the costs of advanced education (as defined in title 10 of the U.S. Code) attributable to such attendance.
5) Included in income only because the qualified education expenses were taken into account in determining the Hope or lifetime learning credit (see chapters 2 and 3).
6) Made before June 1, 2004, of an excess 2003 contribution (and any earnings on it). The distributed earnings must be included in gross income for the year in which the excess contribution was made.

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

Figuring the additional tax. Use Part II of **Form 5329**, *Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts*, to figure any additional tax. Report the amount on Form 1040, line 57.

Worksheet 7–3. **Coverdell ESA — Taxable Distributions and Basis** *(Keep for Your Records)*

How to complete this worksheet.

- Complete Part I, lines A through H, on only one worksheet.
- Complete a separate Part II, lines 1 through 15, for each of your Coverdell ESAs.
- Complete Part III, the Summary (line 16), on only one worksheet.

Part I. Qualified Education Expenses (Complete for total expenses)

A. Enter your total qualified education expenses for 2003		**A.**	
B. Enter those qualified education expenses paid for with tax-free educational assistance (for example, tax-free scholarships, veterans' educational benefits, Pell grants, employer-provided educational assistance)	**B.**		
C. Enter those qualified **higher** education expenses deducted on Schedule C or C–EZ (Form 1040), Schedule F (Form 1040), or as a miscellaneous itemized deduction on Schedule A (Form 1040)	**C.**		
D. Enter those qualified **higher** education expenses on which a Hope or lifetime learning credit was based	**D.**		
E. Add lines B, C, and D		**E.**	
F. Subtract line E from line A. This is your adjusted qualified education expense for 2003		**F.**	
G. Enter your total distributions from **all** Coverdell ESAs during 2003. Do not include rollovers or the return of excess contributions (see instructions)		**G.**	
H. Divide line F by line G. Enter the result as a decimal (rounded to at least 3 places). If the result is 1.000 or more, enter 1.000		**H.**	.

Part II. Taxable Distributions and Basis (Complete separately for each account)

1. Enter the amount contributed to **this** Coverdell ESA for 2003, including contributions made for 2003 from January 1, 2004, through April 15, 2004. Do **not** include rollovers or the return of excess contributions		**1.**	
2. Enter your basis in **this** Coverdell ESA as of December 31, 2002 (see instructions)		**2.**	
3. Add lines 1 and 2		**3.**	
4. Enter the total distributions from **this** Coverdell ESA during 2003. Do **not** include rollovers or the return of excess contributions (see instructions)		**4.**	
5. Multiply line 4 by line H. This is the amount of adjusted qualified education expense attributable to this Coverdell ESA	**5.**		
6. Subtract line 5 from line 4	**6.**		
7. Enter the total value of **this** Coverdell ESA as of December 31, 2003, plus any outstanding rollovers (see instructions)	**7.**		
8. Add lines 4 and 7	**8.**		
9. Divide line 3 by line 8. Enter the result as a decimal (rounded to at least 3 places). If the result is 1.000 or more, enter 1.000	**9.** .		
10. Multiply line 4 by line 9. This is the amount of basis allocated to your distributions, and is tax free		**10.**	
Note: *If line 6 is zero, skip lines 11 through 13, enter -0- on line 14, and go to line 15.*			
11. Subtract line 10 from line 4		**11.**	
12. Divide line 5 by line 4. Enter the result as a decimal (rounded to at least 3 places). If the result is 1.000 or more, enter 1.000	**12.** .		
13. Multiply line 11 by line 12. This is the amount of qualified education expenses allocated to your distributions, and is tax free		**13.**	
14. Subtract line 13 from line 11. This is the **portion of the distributions from this Coverdell ESA in 2003 that you must include in income**		**14.**	
15. Subtract line 10 from line 3. This is your **basis in this Coverdell ESA as of December 31, 2003**		**15.**	

Part III. Summary (Complete only once)

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

Worksheet 7–3 Instructions. **Coverdell ESA — Taxable Distributions and Basis**

Line G. Enter the total distributions received from **all** Coverdell ESAs during 2003. Do not include amounts rolled over to another ESA within 60 days (only one rollover is allowed during any 12-month period). Also, do not include excess contributions that were distributed with the related earnings (or less any loss) before the first day of the sixth month of the tax year following the year for which the contributions were made.

Line 2. Your basis (amount already taxed) in **this** Coverdell ESA as of December 31, 2002, is the total of:

- All contributions to this Coverdell ESA before 2003
- Minus the tax-free portion of any distributions from this Coverdell ESA before 2003.

If your last distribution from this Coverdell ESA was before 2002, you must start with the basis in your account as of the end of the last year in which you took a distribution. You can find that amount on the last line of the worksheet in the Instructions for Form 8606, *Nondeductible IRAs*, that you completed for that year. You can determine your basis in this Coverdell ESA as of December 31, 2002, by adding to the basis as of the end of that year any contributions made to that account after the year of the distribution and before 2003.

Line 4. Enter the total distributions received from **this** Coverdell ESA in 2003. Do not include amounts rolled over to another Coverdell ESA within 60 days (only one rollover is allowed during any 12-month period).

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

Line 7. Enter the total value of **this** Coverdell ESA as of December 31, 2003, plus any outstanding rollovers contributed to the account after 2002, but before the end of the 60-day rollover period. A statement should be sent to you by February 2, 2004, for this Coverdell ESA showing the value on December 31, 2003.

A **rollover** is a tax-free withdrawal from one Coverdell ESA that is contributed to another Coverdell ESA. An **outstanding rollover** is any amount withdrawn within 60 days before the end of 2003 (November 2 through December 31) that was rolled over after December 31, 2003, but within the 60-day rollover period.

When Assets Must Be Distributed

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

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

Exception for Transfer to Surviving Spouse or Family Member

If a Coverdell ESA is transferred to a surviving spouse or other family member as the result of the death of the designated beneficiary, the Coverdell ESA retains its status. (Family member was defined earlier under *Rollovers.*) This means the spouse or other family member can treat the Coverdell ESA as his or her own and does not need to withdraw the assets until he or she reaches age 30. This age limitation does not apply if the new beneficiary is a special needs beneficiary. There are no tax consequences as a result of the transfer.

How To Figure the Taxable Earnings

When a total distribution is made because the designated beneficiary either reached age 30 or died, 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 distributed by a fraction. The numerator is the basis (contributions not previously distributed) at the end of 2002 plus total contributions for 2003 and the denominator is the balance in the account at the end of 2003 plus the amount distributed during 2003.
2) Subtract the amount figured in (1) from the total amount distributed during 2003. The result is the amount of earnings included in the distribution.

For an example, see steps (1) and (2) of the *Example* under *Figuring the Taxable Portion of a Distribution*, earlier.

The beneficiary or other person receiving the distribution must report this amount on Form 1040, line 21, listing the type and amount of income on the dotted line.

8.

Qualified Tuition Program (QTP)

Important Change for 2004

Distributions from eligible educational institution QTPs may be tax free. Beginning in 2004, you may not have to include in income a distribution from a QTP established and maintained by an eligible educational institution.

Introduction

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

What is the tax benefit of a QTP. No tax is due on a distribution from a state-sponsored QTP unless the amount distributed is greater than the beneficiary's adjusted qualified education expenses. See *Are Distributions Taxable*, later, for more information.

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

What Is a Qualified Tuition Program

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

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

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

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

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

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

CAUTION *As of this printing, regulations defining a* **special needs beneficiary** *have not been released. If available, the definition will be included in Publication 553,* Highlights of 2003 Tax Changes*, which will be issued in early 2004.*

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

Eligible educational institution. For purposes of a QTP, 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 education expenses of the beneficiary. There are no income restrictions on the individual contributors.

You can contribute to both a QTP and a Coverdell ESA in the same year for the same designated beneficiary.

Are Distributions Taxable

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

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

Earnings and return of investment. You will receive a **Form 1099–Q**, *Payments From Qualified Education Programs (Under Sections 529 and 530)*, from each of the programs from which you received a QTP distribution in 2003. The amount of your gross distribution (box 1) shown on each form will be divided between your earnings (box 2) and your basis, or return of investment (box 3). Form 1099–Q should be sent to you by February 2, 2004.

Figuring the Taxable Portion of a Distribution

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

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

- The tax-free part of scholarships and fellowships (see chapter 1),
- Veterans' educational assistance (see chapter 1),
- Pell grants (see chapter 1),
- Employer-provided educational assistance (see chapter 11), and
- Any other nontaxable (tax-free) payments (other than gifts or inheritances) received as educational assistance.

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

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

Example. In 1997, Sara Clarke's parents opened a savings account for her with a QTP maintained by their state government. Over the years they contributed $18,000 to the account. The total balance in the account was $27,000 on the date the distribution was made. In the summer of 2003, Sara enrolled in college and had $6,500 of qualified education expenses for the rest of the year. She paid her college expenses from the following sources.

Partial tuition scholarship (tax-free)	$3,000
QTP distribution	3,600

Before Sara can determine the taxable part of her QTP distribution, she must reduce her total qualified education expenses by any tax-free educational assistance.

Total qualified education expenses	$6,500
Minus: Tax-free educational assistance	–3,000
Equals: Adjusted qualified education expenses (AQEE)	$3,500

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

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

1) $1,200 (earnings) $\times \frac{\$3{,}500 \text{ AQEE}}{\$3{,}600 \text{ distribution}}$
= $1,166 (tax-free earnings)

2) $1,200 (earnings) – $1,166 (tax-free earnings)
= $34 (taxable earnings)

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

Coordination With Hope and Lifetime Learning Credits

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

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

Total qualified education expenses	$6,500
Minus: Tax-free educational assistance	–3,000
Minus: Expenses taken into account in figuring Hope credit	–2,000
Equals: Adjusted qualified education expenses (AQEE)	$1,500

The taxable part of the distribution is figured as follows.

1) $1,200 (earnings) $\times \frac{\$1{,}500 \text{ AQEE}}{\$3{,}600 \text{ distribution}}$
= $500 (tax-free earnings)

2) $1,200 (earnings) – $500 (tax-free earnings)
= $700 (taxable earnings)

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

Coordination With Coverdell ESA Distributions

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

Example. Assume the same facts as in the last example for Sara Clarke, except that instead of receiving a

$3,600 distribution from her QTP, Sara received $3,000 from that account and $600 from her Coverdell ESA. In this case, Sara must allocate her adjusted qualified education expenses ($1,500) between the two distributions.

$$\begin{array}{c} \$1{,}500 \\ \text{AQEE} \end{array} \times \frac{\$600 \text{ ESA distribution}}{\$3{,}600 \text{ total distribution}} = \begin{array}{c} \$250 \\ \text{AQEE (ESA)} \end{array}$$

$$\begin{array}{c} \$1{,}500 \\ \text{AQEE} \end{array} \times \frac{\$3{,}000 \text{ QTP distribution}}{\$3{,}600 \text{ total distribution}} = \begin{array}{c} \$1{,}250 \\ \text{AQEE (QTP)} \end{array}$$

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

Note. If you are required to allocate your expenses between Coverdell ESA and QTP distributions, and you have adjusted qualified elementary and secondary education expenses, see the examples in chapter 7 under *Coordination With Qualified Tuition Program (QTP) Distributions*.

Losses on QTP Investments

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

If you have distributions from more than one QTP account during a year, you must combine the information (amount of distribution, basis, etc.) from all such accounts in order to determine your taxable earnings for the year. By doing this, the loss from one QTP account reduces the distributed earnings (if any) from any other QTP accounts.

Example 1. In 2003, Taylor received a final distribution of $1,000 from QTP #1 . His unrecovered basis in that account before the distribution was $3,000. If Taylor itemizes his deductions, he can claim the $2,000 loss on Schedule A.

Example 2. Assume the same facts as in *Example 1*, except that Taylor also had a distribution of $9,000 from QTP #2, giving him total distributions for 2003 of $10,000. His total basis in these distributions was $4,500 — $3,000 for QTP #1 and $1,500 for QTP #2. Taylor's adjusted qualified education expenses for 2003 totaled $6,000. In order to figure his taxable earnings, Taylor combines the two accounts and determines his taxable earnings as follows.

1) $10,000 (total distribution) – $4,500 (basis portion of distribution)
   = $5,500 (earnings included in distribution)

2) $\$5{,}500 \text{ (earnings)} \times \frac{\$6{,}000 \text{ AQEE}}{\$10{,}000 \text{ distribution}}$
   = $3,300 (tax-free earnings)

3) $5,500 (earnings) – $3,300 (tax-free earnings)
   = $2,200 (taxable earnings)

Taylor must include $2,200 in income on Form 1040, line 21. Because Taylor's accounts must be combined, he cannot deduct his $2,000 loss (QTP #1) on Schedule A. Instead, the $2,000 loss reduces the total earnings that were distributed, thereby reducing his taxable earnings.

Additional Tax on Taxable Distributions

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

Exceptions. The 10% additional tax does not apply to distributions:

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) Included in income because the designated beneficiary received:
   a) A tax-free scholarship or fellowship (see chapter 1),
   b) Veterans' educational assistance (see chapter 1),
   c) Employer-provided educational assistance (see chapter 11), or
   d) Any other nontaxable (tax-free) payments (other than gifts or inheritances) received as educational assistance.
4) Made on account of the attendance of the designated beneficiary at a U.S. military academy (such as West Point). This exception applies only to the extent that the amount of the distribution does not exceed the costs of advanced education (as defined in title 10 of the U.S. Code) attributable to such attendance.
5) Included in income only because the qualified education expenses were taken into account in determining the Hope or lifetime learning credit.
6) Made before 2004 and used for qualified education expenses, but included in income because it was paid from a QTP established and maintained by an eligible educational institution.

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

Figuring the additional tax. Use Part II of **Form 5329**, *Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts*, to figure any additional tax. Report the amount on Form 1040, line 57.

Rollovers and Other Transfers

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

Rollovers

Any amount distributed from a QTP and rolled over to another QTP for the benefit of the same beneficiary or for the benefit of a member of the beneficiary's family (including the beneficiary's spouse) is not taxable. An amount is rolled over if it is paid to another QTP within 60 days after the date of the distribution.

Members of the beneficiary's family. For these purposes, the beneficiary's family includes the beneficiary's spouse and the following other relatives of the beneficiary.

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

CAUTION *Only one rollover per QTP is allowed during the 12-month period ending on the date of the payment or distribution.*

Changing the Designated Beneficiary

There are no tax consequences if the designated beneficiary of an account is changed to a member of the beneficiary's family (defined above).

9.

Early Distributions From IRAs

Introduction

Generally, if you take a distribution from your IRA before you reach age 59½, you must pay a 10% additional tax on the early distribution. This applies to any IRA you own, whether it is a traditional IRA (including a SEP-IRA), a Roth IRA, or a SIMPLE IRA. The additional tax on an early distribution from a SIMPLE IRA may be as high as 25%. See Publication 560, *Retirement Plans for Small Business*, for information on SEP-IRAs, and Publication 590, *Individual Retirement Arrangements (IRAs)*, for information about all other IRAs.

However, you can take distributions from your IRAs for ***qualified education expenses*** without having to pay the 10% additional tax. You may owe income tax on at least part of the amount distributed, but you may not have to pay the 10% additional tax.

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

Who Is Eligible

You can take a distribution from your IRA before you reach age 59½ and not have to pay the 10% additional tax if, for the year of the distribution, you pay ***qualified education expenses*** for:

- yourself,
- your spouse, or
- your or your spouse's children or grandchildren.

Qualified education expenses. For purposes of the 10% additional tax, these expenses are tuition, fees, books, supplies, and equipment required for enrollment or attendance at an ***eligible educational institution***. They also include expenses for special needs services incurred by or for special needs students in connection with their enrollment or attendance.

CAUTION *As of this printing, regulations defining a* **special needs student** *have not been released. If available, the definition will be included in Publication 553,* Highlights of 2003 Tax Changes*, which will be issued in early 2004.*

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

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

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

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

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

Figuring the Amount Not Subject to the 10% Tax

To determine the amount of your distribution that is not subject to the 10% additional tax, first find your ***adjusted qualified education expenses***. You do this by reducing your total qualified education expenses by any tax-free educational assistance, which includes:

- Distributions from a Coverdell education savings account (ESA) (see chapter 7),
- The tax-free part of scholarships and fellowships (see chapter 1),
- Pell grants (see chapter 1),
- Veterans' educational assistance (see chapter 1),
- Employer-provided educational assistance (see chapter 11), and
- Any other nontaxable (tax-free) payments (other than gifts or inheritances) received as educational assistance.

Do not reduce the qualified education expenses by amounts paid with funds the student receives as:

- Payment for services, such as wages,
- A loan,
- A gift,
- An inheritance given to either the student or the individual making the withdrawal, or
- A withdrawal from personal savings (including savings from a qualified tuition program (QTP)).

If your IRA distribution is equal to or less than your adjusted qualified education expenses, you are not subject to the 10% additional tax.

Example 1. In 2003, Erin (age 32) took a year off from teaching to attend graduate school full time. She paid $5,800 of qualified education expenses from the following sources.

Employer-provided educational assistance (tax free)	$1,500
Early distribution from IRA (includes $500 taxable earnings)	3,200
Savings account	1,100

Before Erin can determine if she must pay the 10% additional tax on her IRA distribution, she must reduce her total qualified education expenses.

Total qualified education expenses	$5,800
Minus: Tax-free educational assistance	–1,500
Equals: Adjusted qualified education expenses (AQEE)	$4,300

Because Erin's AQEE ($4,300) are more than her IRA distribution ($3,200), she does not have to pay the 10% additional tax on any part of this distribution. However, she must include the $500 taxable earnings in her gross income subject to income tax.

Example 2. Assume the same facts as in *Example 1*, except that the assistance from Erin's employer was delayed (not received until July 2003), so she withdrew $4,500 from her IRA instead of the smaller amount. This included $700 of taxable earnings, which must be included in her income subject to income tax.

Erin's IRA distribution ($4,500) is larger than her AQEE ($4,300). Therefore, she must pay the 10% additional tax on $200, the amount of her distribution ($4,500) that is more than her qualified education expenses ($4,300), but not more than the taxable amount of her distribution ($700). She does not have to pay the 10% additional tax on the remaining $500 of her taxable distribution.

Example 3. Assume the same facts as in *Example 1* and *Example 2*, except that Erin's early distribution from her IRA was $5,500 (including $850 of taxable earnings). The excess of her distribution ($5,500) over her qualified education expenses ($4,300) is $1,200. Because the excess distribution ($1,200) is greater than the taxable earnings ($850), Erin must pay the 10% additional tax on the entire $850 of taxable earnings.

Reporting Early Distributions

By February 2, 2004, the payer of your IRA distribution should send you **Form 1099–R**, *Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.* The information on this form will help you determine how much of your distribution is taxable for income tax purposes and how much is subject to the 10% additional tax.

If you received an early distribution from your IRA, you must report the taxable earnings on Form 1040, line 15b. Then, in order to show how much, if any, of your early distribution is subject to the 10% additional tax, you generally must file **Form 5329**. See the instructions for Form 5329, Part I, for help in completing the form and entering the results on Form 1040.

However, you do not have to file Form 5329 for this distribution if either of the following is true.

1) Box 7 of the Form 1099–R you received for this distribution shows code 2, and you have determined that you are not subject to the 10% additional tax.
2) Box 7 of Form 1099–R for this distribution shows code 1 and you are subject to the 10% additional tax on ***all*** of your taxable earnings.

   In this case, multiply the taxable amount of your distribution by 10% (.10) and enter the result on line 57. Also, put "No" under the heading *Other Taxes* to the left of line 57 to indicate that you do not have to file Form 5329.

There are many other situations in which Form 5329 is required. If, during 2003, you had other distributions from IRAs or qualified retirement plans, or have made excess contributions to certain tax-favored accounts, see the instructions for line 57 (Form 1040) to determine if you must file Form 5329.

10.

Education Savings Bond Program

Important Change for 2003

Income limits for exclusion reduction increased. For 2003, the amount of your interest exclusion will be phased out (gradually reduced) if your filing status is married filing jointly or qualifying widow(er) ***and*** your MAGI is between $87,750 and $117,750. You cannot take the deduction if your MAGI is $117,750 or more. For 2002, the limits that applied to you were $86,400 and $116,400.

For all other filing statuses, your interest exclusion is phased out if your MAGI is between $58,500 and $73,500. You cannot take the deduction if your MAGI is $73,500 or more. For 2002, the limits that applied to you were $57,600 and $72,600. See *Effect of the Amount of Your Income on the Amount of Your Exclusion*, later.

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 education expenses*** for yourself, your spouse, or a ***dependent for whom you claim an exemption*** on your return.
- Your ***modified adjusted gross income (MAGI)*** is less than $73,500 ($117,750 if filing a joint return).
- Your filing status is not married filing separately.

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

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

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

Qualified 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 education expenses do ***not*** include expenses for room and board or for courses involving sports, games, or hobbies that are not part of a degree or certificate granting program.
2) Contributions to a qualified tuition program (QTP) (see chapter 8).
3) Contributions to a Coverdell education savings account (ESA), formerly known as an education IRA (see chapter 7).

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

1) Tax-free part of scholarships and fellowships (see chapter 1).
2) Expenses used to figure the tax-free portion of distributions from a Coverdell ESA (see chapter 7).
3) Expenses used to figure the tax-free portion of distributions from a QTP (see chapter 8).
4) Any nontaxable tax-free payments (other than gifts or inheritances) received as educational assistance, such as:
   a) Veterans' educational assistance benefits (see chapter 1),
   b) Qualified tuition reductions (see chapter 1), or
   c) Employer-provided educational assistance (see chapter 11).
5) Any expenses used in figuring the Hope and lifetime learning credits (see chapters 2 and 3).

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

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

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

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

1) Exclusion for adoption benefits received under an employer's adoption assistance program,

2) Deduction for student loan interest, and

3) Deduction for tuition and fees.

MAGI when using Form 1040. If you file Form 1040, your MAGI is the AGI on line 35 of that form figured without taking into account any savings bond interest exclusion and modified by adding back any:

1) Foreign earned income exclusion,

2) Foreign housing exclusion,

3) Foreign housing deduction,

4) Exclusion of income for bona fide residents of American Samoa,

5) Exclusion of income from Puerto Rico,

6) Exclusion for adoption benefits received under an employer's adoption assistance program,

7) Deduction for student loan interest, and

8) Deduction for tuition and fees.

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

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), Supplemental Income and Loss*, you must make a special computation of your deductible interest without regard to this exclusion to figure the net royalty income included in your modified AGI. See* Royalties included in modified AGI *under* Education Savings Bond Program *in chapter 1 of Publication 550.*

Figuring the Tax-Free Amount

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

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

Example. In February 2003, Mark and Joan Washington, a married couple, cashed a qualified series EE U.S. savings bond they bought in November 1994. They received proceeds of $9,000, representing principal of $6,000 and interest of $3,000. In 2003, they paid $7,650 of their daughter's college tuition. They are not claiming a Hope or lifetime learning credit for that amount, and their daughter does not have any tax-free educational assistance. Their MAGI for 2003 was $80,000.

$$\begin{array}{c}\$3{,}000\\ \text{interest}\end{array} \times \frac{\$7{,}650 \text{ expenses}}{\$9{,}000 \text{ proceeds}} = \begin{array}{c}\$2{,}550\\ \text{tax-free}\\ \text{interest}\end{array}$$

They can exclude $2,550 of interest in 2003. They must pay tax on the remaining $450 ($3,000 – $2,550) interest.

Effect of the Amount of Your Income on the Amount of Your Exclusion

The amount of your interest exclusion is gradually reduced (phased out) if your modified adjusted gross income is between $58,500 and $73,500 (between $87,750 and $117,750 if your filing status is married filing jointly or qualifying widow(er)). You cannot exclude any of the interest if your modified adjusted gross income is equal to or more than the upper limit.

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

Claiming the Exclusion

Use **Form 8815** to figure your education savings bond interest exclusion. Enter your exclusion on line 3 of Schedule B (Form 1040), *Interest and Ordinary Dividends*, or Schedule 1 (Form 1040A), *Interest and Ordinary Dividends for Form 1040A Filers*. Attach Form 8815 to your tax return.

Illustrated Example

The information is the same as in the previous example for Mark and Joan Washington, except they have a modified adjusted gross income of $104,400. In this example, they can exclude $1,135 (line 14 of Form 8815 shown on the next page) of interest in 2003.

They must pay tax on the remaining $1,865 interest ($3,000 total interest minus $1,135 excluded interest).

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

2003

Attachment Sequence No. **57**

Name(s) shown on return	Your social security number
Mark & Joan Washington	000 : 00 : 4567

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

If you need more space, attach a statement.

2	Enter the total qualified higher education expenses you paid in 2003 for the person(s) listed in column (a) of line 1. See the instructions to find out which expenses qualify	**2**	7,650
3	Enter the total of any nontaxable educational benefits (such as nontaxable scholarship or fellowship grants) received for 2003 for the person(s) listed in column (a) of line 1 (see instructions)	**3**	0
4	Subtract line 3 from line 2. If zero or less, **stop.** You **cannot** take the exclusion	**4**	7,650
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 2003**	**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**	× .850
8	Multiply line 6 by line 7	**8**	2,550
9	Enter your modified adjusted gross income (see instructions) **9** 104,400 **Note:** *If line 9 is $73,500 or more if single or head of household, or $117,750 or more if married filing jointly or qualifying widow(er),* ***stop.*** *You* ***cannot*** *take the exclusion.*		
10	Enter: $58,500 if single or head of household; $87,750 if married filing jointly or qualifying widow(er) **10** 87,750		
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** 16,650		
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**	× .555
13	Multiply line 8 by line 12	**13**	1,415
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**	1,135

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 2003 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 2003 that were issued after 1989.

2. You paid qualified higher education expenses in 2003 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: $73,500 if single or head of household; $117,750 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 2003.
- 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** (2003)

11. Employer-Provided Educational Assistance

Introduction

If you receive ***educational assistance benefits*** from your employer under an ***educational assistance program***, you can exclude up to $5,250 of those benefits each year. This means your employer should not include the benefits with your wages, tips, and other compensation shown in box 1 of your Form W–2. This also means that you do not have to include the benefits on your income tax return.

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.

Educational assistance program. To qualify as an educational assistance program, the plan must be written and must meet certain other requirements. Your employer can tell you whether there is a qualified program where you work.

Educational assistance benefits. Tax-free educational assistance benefits include payments for tuition, fees and similar expenses, books, supplies, and equipment. For courses beginning on or after January 1, 2002, the payments may be for either undergraduate- or graduate-level courses. The payments do not have to be for work-related courses.

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

1) Meals, lodging, or transportation.
2) Tools or supplies (other than textbooks) that you can keep after completing the course of instruction.
3) 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.

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

Working condition fringe benefit. However, if the benefits over $5,250 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*.

12. Business Deduction for Work-Related Education

Important Changes for 2003

Standard mileage rate. Generally, if you claim a business deduction for work-related education and you drive your car to and from school, the amount you can deduct in 2003 is 36 cents per mile, down from 36½ cents per mile in 2002. See *Transportation Expenses* under *What Expenses Can Be Deducted*, for more information.

Limit on itemized deductions. If your adjusted gross income for 2003 is more than $139,500 ($69,750 if you are married filing separately), your itemized deductions may be limited. See *Employees* under *Deducting Business Expenses*, and the instructions for line 28 of Schedule A (Form 1040).

Introduction

This chapter discusses work-related education expenses that you may be able to deduct as business expenses.

To claim such a deduction, you must:

1) Be working,
2) Itemize your deductions on Schedule A (Form 1040) ***if you are an employee***,
3) File Schedule C (Form 1040) or Schedule F (Form 1040) ***if you are self-employed***, and
4) Have expenses for education that meet the requirements discussed under *Qualifying Work-Related Education.*

What is the tax benefit of taking a business deduction for work-related education. If you are an employee and able to itemize your deductions, you may be able to claim a deduction for the expenses you pay for your work-related education. Your deduction will be the amount by which your ***qualifying work-related education*** expenses plus other job and certain miscellaneous expenses is greater than 2% of your adjusted gross income. An itemized deduction reduces the amount of your income subject to tax.

If you are self-employed, you deduct your expenses for qualifying work-related education directly from your self-employment income. This reduces the amount of your income subject to both income tax and self-employment tax.

Your work-related education expenses may also qualify you for other tax benefits, such as the tuition and fees deduction and the Hope and lifetime learning credits. You may qualify for these other benefits even if you do not meet the requirements listed above.

Also, keep in mind that your work-related education expenses may qualify you to claim more than one tax benefit. Generally, you may claim any number of benefits as long as you use different expenses to figure each one.

TIP *When you figure your taxes, you may want to compare these tax benefits so you can choose the method(s) that give you the lowest tax liability. First, figure your taxes using the expenses as business deductions. Then, figure your taxes again using any of the other deductions and credits for which you qualify. You may find that a combination of credit(s) and deduction(s) gives you the lowest tax.*

Qualifying Work-Related Education

You can deduct the costs of qualifying work-related education as business expenses. This is education that meets ***at least one*** of the following two tests.

1) The education is ***required by your employer or the law*** to keep your present salary, status, or job. The required education must serve a bona fide business purpose of your employer.
2) The education ***maintains or improves skills*** needed in your present work.

However, even if the education meets one or both of the above tests, it is not qualifying work-related education if it:

1) Is needed to meet the ***minimum educational requirements*** of your present trade or business, or
2) Is part of a program of study that will ***qualify you for a new trade or business***.

You can deduct the costs of qualifying work-related education as a business expense even if the education could lead to a degree.

Use *Figure 12–1* (see next page) as a quick check to see if your education qualifies.

Education Required by Employer or by Law

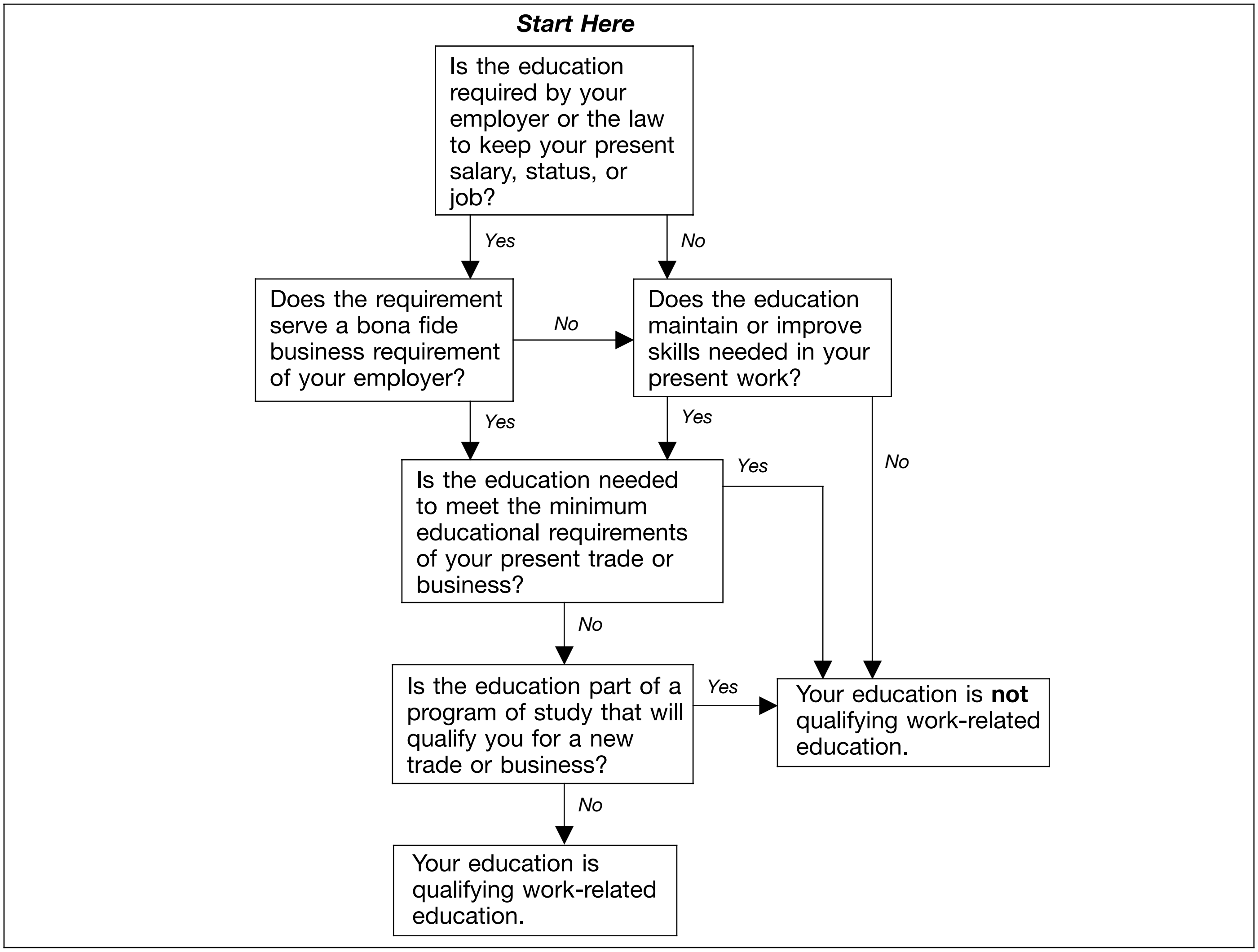
Once you have met the minimum educational requirements for your job, your employer or the law may require you to get more education. This additional education is qualifying work-related education if ***all*** three of the following requirements are met.

1) It is required for you to keep your present salary, status, or job,
2) The requirement serves a business purpose of your employer, and
3) The education is not part of a program that will qualify you for a new trade or business.

When you get more education than your employer or the law requires, the additional education can be qualifying work-related education only if it maintains or improves skills required in your present work. See *Education To Maintain or Improve Skills*, on the next page.

Example. You are a teacher who has satisfied the minimum requirements for teaching. Your employer requires

Figure 12-1. **Does Your Work-Related Education Qualify?**



you to take an additional college course each year to keep your teaching job. If the courses will not qualify you for a new trade or business, they are qualifying work-related education even if you eventually receive a master's degree and an increase in salary because of this extra education.

Education To Maintain or Improve Skills

If your education is not required by your employer or the law, it can be qualifying work-related education only if it maintains or improves skills needed in your present work. This could include refresher courses, courses on current developments, and academic or vocational courses.

Example. You repair televisions, radios, and stereo systems for XYZ Store. To keep up with the latest changes, you take special courses in radio and stereo service. These courses maintain and improve skills required in your work.

Maintaining skills vs. qualifying for new job. Education to maintain or improve skills needed in your present work is not qualifying education if it will also qualify you for a new trade or business.

Temporary absence. If you stop working for a year or less in order to get education to maintain or improve skills needed in your present work and then return to the same general type of work, your absence is considered temporary. Education that you get during a temporary absence is qualifying work-related education if it maintains or improves skills needed in your present work.

Example. You quit your biology research job to become a full-time biology graduate student for one year. If you return to work in biology research after completing the courses, the education is related to your present work even if you do not go back to work with the same employer.

Indefinite absence. If you stop work for more than a year, your absence from your job is considered indefinite. Education during an indefinite absence, even if it maintains or improves skills needed in the work from which you are absent, is considered to qualify you for a new trade or business. Therefore, it is not qualifying work-related education.

Education To Meet Minimum Requirements

Education you need to meet the minimum educational requirements for your present trade or business is not qualifying work-related education. The minimum educational requirements are determined by:

1) Laws and regulations,
2) Standards of your profession, trade, or business, and
3) Your employer.

Once you have met the minimum educational requirements that were in effect when you were hired, you do not have to meet any new minimum educational requirements. This means that if the minimum requirements change after you were hired, any education you need to meet the new requirements can be qualifying education.

CAUTION

You have not necessarily met the minimum educational requirements of your trade or business simply because you are already doing the work.

Example 1. You are a full-time engineering student. Although you have not received your degree or certification, you work part time as an engineer for a firm that will employ you as a full-time engineer after you finish college. Although your college engineering courses improve your skills in your present job, they are also needed to meet the minimum job requirements for a full-time engineer. The education is not qualifying work-related education.

Example 2. You are an accountant and you have met the minimum educational requirements of your employer. Your employer later changes the minimum educational requirements and requires you to take college courses to keep your job. These additional courses can be qualifying work-related education because you have already satisfied the minimum requirements that were in effect when you were hired.

Requirements for Teachers

States or school districts usually set the minimum educational requirements for teachers. The requirement is the college degree or the minimum number of college hours usually required of a person hired for that position.

If there are no requirements, you will have met the minimum educational requirements when you become a faculty member. You generally will be considered a faculty member when ***one or more*** of the following occurs.

1) You have tenure.
2) Your years of service count toward obtaining tenure.
3) You have a vote in faculty decisions.
4) Your school makes contributions for you to a retirement plan other than social security or a similar program.

Example 1. The law in your state requires beginning secondary school teachers to have a bachelor's degree, including 10 professional education courses. In addition, to keep the job a teacher must complete a fifth year of training within 10 years from the date of hire. If the employing school certifies to the state Department of Education that qualified teachers cannot be found, the school can hire persons with only 3 years of college. However, to keep their jobs, these teachers must get a bachelor's degree and the required professional education courses within 3 years.

Under these facts, the bachelor's degree, whether or not it includes the 10 professional education courses, is considered the minimum educational requirement for qualification as a teacher in your state.

If you have all the required education except the fifth year, you have met the minimum educational requirements. The fifth year of training is qualifying work-related education unless it is part of a program of study that will qualify you for a new trade or business.

Example 2. Assume the same facts as in *Example 1* except that you have a bachelor's degree and only six professional education courses. The additional four education courses can be qualifying work-related education. Although you do not have all the required courses, you have already met the minimum educational requirements.

Example 3. Assume the same facts as in *Example 1* except that you are hired with only 3 years of college. The courses you take that lead to a bachelor's degree (including those in education) are not qualifying work-related education. They are needed to meet the minimum educational requirements for employment as a teacher.

Example 4. You have a bachelor's degree and you work as a temporary instructor at a university. At the same time, you take graduate courses toward an advanced degree. The rules of the university state that you can become a faculty member only if you get a graduate degree. Also, you can keep your job as an instructor only as long as you show satisfactory progress toward getting this degree. You have not met the minimum educational requirements to qualify you as a faculty member. The graduate courses are not qualifying work-related education.

Certification in a new state. Once you have met the minimum educational requirements for teachers for your state, you are considered to have met the minimum educational requirements in all states. This is true even if you must get additional education to be certified in another state. Any additional education you need is qualifying work-related education. You have already met the minimum requirements for teaching. Teaching in another state is not a new trade or business.

Example. You hold a permanent teaching certificate in State A and are employed as a teacher in that state for several years. You move to State B and are promptly hired as a teacher. You are required, however, to complete certain prescribed courses to get a permanent teaching certificate in State B. These additional courses are qualifying work-related education because the teaching position in State B involves the same general kind of work for which you were qualified in State A.

Education That Qualifies You for a New Trade or Business

Education that is part of a program of study that will qualify you for a new trade or business is not qualifying work-related education. This is true even if you do not plan to enter that trade or business.

If you are an employee, a change of duties that involves the same general kind of work is not a new trade or business.

Example 1. You are an accountant. Your employer requires you to get a law degree at your own expense. You register at a law school for the regular curriculum that leads to a law degree. Even if you do not intend to become a lawyer, the education is not qualifying because the law degree will qualify you for a new trade or business.

Example 2. You are a general practitioner of medicine. You take a 2-week course to review developments in several specialized fields of medicine. The course does not qualify you for a new profession. It is qualifying work-related education because it maintains or improves skills required in your present profession.

Example 3. While working in the private practice of psychiatry, you enter a program to study and train at an accredited psychoanalytic institute. The program will lead to qualifying you to practice psychoanalysis. The psychoanalytic training does not qualify you for a new profession. It is qualifying work-related education because it maintains or improves skills required in your present profession.

Bar or CPA Review Course

Review courses to prepare for the bar examination or the certified public accountant (CPA) examination are not qualifying work-related education. They are part of a program of study that can qualify you for a new profession.

Teaching and Related Duties

All teaching and related duties are considered the same general kind of work. A change in duties in any of the following ways is not considered a change to a new business.

1) Elementary school teacher to secondary school teacher.
2) Teacher of one subject, such as biology, to teacher of another subject, such as art.
3) Classroom teacher to guidance counselor.
4) Classroom teacher to school administrator.

What Expenses Can Be Deducted

If your education meets the requirements described earlier under *Qualifying Work-Related Education,* you can generally deduct your education expenses as business expenses. If you are not self-employed, you can deduct business expenses only if you itemize your deductions.

You cannot deduct expenses related to tax-exempt and excluded income.

Deductible expenses. The following education expenses can be deducted.

1) Tuition, books, supplies, lab fees, and similar items.
2) Certain transportation and travel costs.
3) Other education expenses, such as costs of research and typing when writing a paper as part of an educational program.

Nondeductible expenses. You cannot deduct personal or capital expenses. For example, you cannot deduct the dollar value of vacation time or annual leave you take to attend classes. This amount is a personal expense.

Unclaimed reimbursement. If you do not claim reimbursement that you are entitled to receive from your employer, you cannot deduct the expenses that apply to the reimbursement.

Example. Your employer agrees to pay your education expenses if you file a voucher showing your expenses. You do not file a voucher and you do not get reimbursed. Because you did not file a voucher, you cannot deduct the expenses on your tax return.

Transportation Expenses

If your education qualifies, you can deduct local transportation costs of going directly from work to school. If you are regularly employed and go to school on a ***temporary basis***, you can also deduct the costs of returning from school to home.

Temporary basis. You go to school on a temporary basis if either of the following situations applies to you.

1) Your attendance at school is realistically expected to last ***1 year or less*** and does indeed last for 1 year or less.
2) Initially, your attendance at school is realistically expected to last ***1 year or less***, but at a later date your attendance is reasonably expected to last ***more than 1 year***. Your attendance is temporary up to the date you determine it will last more than 1 year.

If you are in either situation (1) or (2) above, your attendance is ***not*** temporary if facts and circumstances indicate otherwise.

Attendance not on a temporary basis. You do not go to school on a temporary basis if any of the following situations apply to you.

1) Your attendance at school is realistically expected to last ***more than 1 year***. It does not matter how long you actually attend.
2) Initially, your attendance at school is realistically expected to last ***1 year or less***, but at a later date your attendance is reasonably expected to last ***more than 1 year***. Your attendance is not temporary after the date you determine it will last more than 1 year.

Deductible Transportation Expenses

If you are regularly employed and go directly from home to school on a temporary basis, you can deduct the round-trip costs of transportation between your home and school. This is true regardless of the location of the school, the distance traveled, or whether you attend school on non-work days.

Transportation expenses include the actual costs of bus, subway, cab, or other fares, as well as the costs of using your car. Transportation expenses do not include amounts spent for travel, meals, or lodging while you are away from home overnight.

Example 1. You regularly work in a nearby town, and go directly from work to home. You also attend school every work night for 3 months to take a course that improves your job skills. Since you are attending school on a temporary basis, you can deduct your daily round-trip transportation expenses in going between home and school. This is true regardless of the distance traveled.

Example 2. Assume the same facts as in *Example 1* except that on certain nights you go directly from work to school and then home. You can deduct your transportation expenses from your regular work site to school and then home.

Example 3. Assume the same facts as in *Example 1* except that you attend the school for 9 months on Saturdays, nonwork days. Since you are attending school on a temporary basis, you can deduct your round-trip transportation expenses in going between home and school.

Example 4. Assume the same facts as in *Example 1* except that you attend classes twice a week for 15 months. Since your attendance in school is not considered temporary, you cannot deduct your transportation expenses in going between home and school. If you go directly from work to school, you can deduct the one-way transportation expenses of going from work to school. If you go from work to home to school and return home, your transportation expenses cannot be more than if you had gone directly from work to school.

Using your car. If you use your car (whether you own or lease it) for transportation to school, you can deduct your actual expenses or use the standard mileage rate to figure the amount you can deduct. The standard mileage rate for 2003 is 36 cents per mile. Whichever method you use, you can also deduct parking fees and tolls. See Publication 463 for information on deducting your actual expenses of using a car.

Travel Expenses

You can deduct expenses for travel, meals (see *50% limit on meals*, later), and lodging if:

1) You travel overnight to obtain qualifying work-related education, and
2) The main purpose of the trip is to attend a work-related course or seminar.

Travel expenses for qualifying work-related education are treated the same as travel expenses for other employee business purposes. For more information, see Publication 463.

CAUTION

You cannot deduct expenses for personal activities such as sightseeing, visiting, or entertaining.

Mainly personal travel. If your travel away from home is mainly personal, you cannot deduct all of your expenses for travel, meals, and lodging. You can deduct only your expenses for lodging and 50% of your expenses for meals during the time you attend the qualified educational activities.

Whether a trip's purpose is mainly personal or educational depends upon the facts and circumstances. An important factor is the comparison of time spent on personal activities with time spent on educational activities. If you spend more time on personal activities, the trip is considered mainly educational only if you can show a substantial nonpersonal reason for traveling to a particular location.

Example 1. John works in Newark, New Jersey. He traveled to Chicago to take a deductible 1-week course at the request of his employer. His main reason for going to Chicago was to take the course.

While there, he took a sightseeing trip, entertained some friends, and took a side trip to Pleasantville for a day.

Since the trip was mainly for business, John can deduct his round-trip airfare to Chicago. He cannot deduct his transportation expenses of going to Pleasantville. He can deduct only the meals (subject to the 50% limit) and lodging connected with his educational activities.

Example 2. Sue works in Boston. She went to a university in Michigan to take a course for work. The course is qualifying work-related education.

She took one course, which is one-fourth of a full course load of study. She spent the rest of the time on personal activities. Her reasons for taking the course in Michigan were all personal.

Sue's trip is mainly personal because three-fourths of her time is considered personal time. She cannot deduct the cost of her round-trip train ticket to Michigan. She can deduct one-fourth of the meals (subject to the 50% limit) and lodging costs for the time she attended the university.

Example 3. Dave works in Nashville and recently traveled to California to take a 2-week seminar. The seminar is qualifying work-related education.

While there, he spent an extra 8 weeks on personal activities. The facts, including the extra 8-week stay, show that his main purpose was to take a vacation.

Dave cannot deduct his round-trip airfare or his meals and lodging for the 8 weeks. He can deduct only his expenses for meals (subject to the 50% limit) and lodging for the 2 weeks he attended the seminar.

Cruises and conventions. Certain cruises and conventions offer seminars or courses as part of their itinerary. Even if the seminars or courses are work related, your deduction for travel may be limited. This applies to:

1) Travel by ocean liner, cruise ship, or other form of luxury water transportation, and
2) Conventions outside the North American area.

For a discussion of the limits on travel expense deductions that apply to cruises and conventions, see *Luxury Water Travel* and *Conventions* in Publication 463.

50% limit on meals. You can deduct only 50% of the cost of your meals while traveling away from home to obtain qualifying work-related education. You cannot have been reimbursed for the meals.

Employees must use Form 2106 or Form 2106−EZ to apply the 50% limit.

Travel as Education

You cannot deduct the cost of travel as a form of education even if it is directly related to your duties in your work or business.

Example. You are a French language teacher. While on sabbatical leave granted for travel, you traveled through France to improve your knowledge of the French language. You chose your itinerary and most of your activities to improve your French language skills. You cannot deduct your travel expenses as education expenses. This is true even if you spent most of your time learning French by visiting French schools and families, attending movies or plays, and engaging in similar activities.

No Double Benefit Allowed

You cannot do any of the following.

- Deduct work-related education expenses as business expenses if you deduct these expenses under any other provision of the law, for example, as a tuition and fees deduction.
- Deduct work-related education expenses paid with tax-free scholarship, grant, or employer-provided educational assistance. See *Adjustments to Qualifying Work-Related Education Expenses*, next.

Adjustments to Qualifying Work-Related Education Expenses

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

Tax-free educational assistance. This includes:

- The tax-free part of scholarships and fellowships (see chapter 1),
- Pell grants (see chapter 1),
- Employer-provided educational assistance (see chapter 11),
- Veterans' educational assistance (see chapter 1), and
- Any other nontaxable (tax-free) payments (other than gifts or inheritances) received as educational assistance.

Amounts that do not reduce qualifying work-related education expenses. Do not reduce the qualifying work-related education expenses by amounts paid with funds the student receives as:

- Payment for services, such as wages,
- A loan,
- A gift,
- An inheritance, or
- A withdrawal from the student's personal savings.

Also, do not reduce the qualifying work-related education expenses by any scholarship or fellowship reported as income on the student's return or any scholarship which, by its terms, cannot be applied to qualifying work-related education expenses.

How To Treat Reimbursements

How you treat reimbursements depends on the arrangement you have with your employer.

There are two basic types of reimbursement arrangements — ***accountable plans*** and ***nonaccountable plans.*** You can tell the type of plan you are reimbursed under by the way the reimbursement is reported on your Form W−2.

Note. The following rules about reimbursement arrangements also apply to expense allowances received from your employer.

Accountable Plans

To be an accountable plan, your employer's reimbursement arrangement must require you to meet ***all*** three of the following rules.

1) Your expenses must have a business connection — that is, your expenses must be deductible under the rules for qualifying work-related education explained earlier.
2) You must adequately account to your employer for your expenses within a reasonable period of time.
3) You must return any reimbursement or allowance in excess of the expenses accounted for within a reasonable period of time.

If you are reimbursed under an accountable plan, your employer should not include any reimbursement in your income in box 1 of your Form W−2.

TIP *If your employer included reimbursements in box 1 of your Form W−2 and you meet all three rules for accountable plans, ask your employer for a corrected Form W−2.*

Accountable plan rules not met. Even though you are reimbursed under an accountable plan, some of your expenses may not meet all three rules for accountable plans. Those expenses that fail to meet the three rules are treated as having been reimbursed under a nonaccountable plan (discussed later).

Expenses equal reimbursement. Under an accountable plan, if your expenses equal your reimbursement, you do not complete Form 2106 or 2106−EZ. Because your expenses and reimbursements are equal, you do not have a deduction.

Excess expenses. If your expenses are more than your reimbursement, you can deduct your excess expenses. This is discussed later under *Deducting Business Expenses.*

Allocating your reimbursements for meals. Because your excess meal expenses are subject to the 50% limit, you must figure them separately from your other expenses. If your employer paid you a single amount to cover both meals and other expenses, you must allocate the reimbursement so that you can figure your excess meal expenses separately. You make the allocation as follows.

1) Divide your meal expenses by your total expenses.
2) Multiply your total reimbursement by the result from (1). This is the allocated reimbursement for your meal expenses.
3) Subtract the amount figured in (2) from your total reimbursement. The difference is the allocated reimbursement for your other expenses of qualifying work-related education.

Example. Your employer paid you an expense allowance of $2,000 under an accountable plan. The allowance was to cover all of your expenses of traveling away from home to take a 2-week training course for work. There was no indication of how much of the reimbursement was for each type of expense. Your actual expenses equal $2,500 ($425 for meals + $700 lodging + $150 transportation expenses + $1,225 for books and tuition).

Using the steps listed above, allocate the reimbursement between the $425 meal expenses and the $2,075 other expenses.

1) $\frac{\$425 \text{ meal expenses}}{\$2{,}500 \text{ total expenses}} = .17$

2) $2,000 (reimbursement) × .17
= $340 (allocated reimbursement for meal expenses)

3) $2,000 (reimbursement) − $340 (meals)
= $1,660 (allocated reimbursement for other qualifying work-related education expenses)

Your excess meal expenses are $85 ($425 − $340) and your excess other expenses are $415 ($2,075 − $1,660). After you apply the 50% limit to your meals, you have a deduction for work-related education expenses of $457.50 [($85 × 50%) + $415].

Nonaccountable Plans

Your employer will combine the amount of any reimbursement or other expense allowance paid to you under a nonaccountable plan with your wages, salary, or other pay and report the total in box 1 of your Form W–2.

You can deduct your expenses regardless of whether they are more than, less than, or equal to your reimbursement. This is discussed later under *Deducting Business Expenses*. An illustrated example of a nonaccountable plan, using Form 2106–EZ, is shown at the end of this chapter.

Reimbursements for nondeductible expenses. Reimbursements you received for nondeductible expenses are treated as paid under a nonaccountable plan. You must include them in your income. For example, you must include in your income reimbursements your employer gave you for expenses of education that:

1) You need to meet the minimum educational requirements for your job, or
2) Is part of a program of study that can qualify you for a new trade or business.

For more information on accountable and nonaccountable plans, see Publication 463.

Deducting Business Expenses

Self-employed persons and employees report their business expenses differently.

The following information explains what forms you must use to deduct the cost of your qualifying work-related education as a business expense.

Self-Employed Persons

If you are self-employed, you must report the cost of your qualifying work-related education on the appropriate form used to report your business income and expenses (generally Schedule C, C–EZ, or F). If your educational expenses include expenses for a car or truck, travel, or meals, report those expenses the same way you report other business expenses for those items. See the instructions for the form you file for information on how to complete it.

Employees

If you are an employee, you can deduct the cost of qualifying work-related education only if you:

1) Did not receive any reimbursement from your employer,
2) Were reimbursed under a nonaccountable plan (amount is included in box 1 of Form W–2), or
3) Received reimbursement under an accountable plan, but the amount received was less than your expenses.

If either (1) or (2) applies, you can deduct the total qualifying cost. If (3) applies, you can deduct only the qualifying costs that were more than your reimbursement.

In order to deduct the cost of your qualifying work-related education as a business expense, include the amount with your deduction for any other employee business expenses on line 20 of Schedule A (Form 1040). (Special rules for expenses of certain performing artists and fee-basis officials and for impairment-related work expenses are explained later.)

This deduction is subject to the 2%-of-adjusted-gross-income limit that applies to most miscellaneous itemized deductions. A separate limit may apply to your itemized deductions if your adjusted gross income is more than $139,500 ($69,750 if you are married filing separately). See the instructions for line 28 of Schedule A (Form 1040).

Form 2106 or 2106–EZ. To figure your deduction for employee business expenses, including qualifying work-related education, you generally must complete Form 2106 or 2106–EZ.

Form not required. Do not complete either Form 2106 or 2106–EZ if:

- All reimbursements, if there were any, are included in box 1 of your Form W–2, and
- You are not claiming travel, transportation, meal, or entertainment expenses.

If you meet both of these requirements, enter the expenses directly on line 20 of Schedule A (Form 1040). (Special rules for expenses of certain performing artists and fee-basis officials and for impairment-related work expenses are explained later.)

Using Form 2106–EZ. This form is shorter and easier to use than Form 2106. Generally, you can use this form if:

- All reimbursements, if there were any, are included in box 1 of your Form W–2, and
- You are using the standard mileage rate if you are claiming vehicle expenses.

If you do not meet both of these requirements, use Form 2106.

Performing Artists and Fee-Basis Officials

If you are a qualified performing artist, or a state (or local) government official who is paid in whole or in part on a fee basis, you can deduct the cost of your qualifying work-related education as an adjustment to gross income rather than as an itemized deduction.

Include the cost of your qualifying work-related education with any other employee business expenses on line 33 of Form 1040. You do not have to itemize your deductions on Schedule A (Form 1040), and, therefore, the deduction is not subject to the 2%-of-adjusted-gross-income limit. You must complete Form 2106 or 2106–EZ to figure your deduction even if you meet the requirements described earlier under *Form not required.*

For more information on qualified performing artists, see Publication 463.

Impairment-Related Work Expenses

If you are disabled and have impairment-related work expenses that are necessary for you to be able to get qualifying work-related education, you can deduct these expenses on line 27 of Schedule A (Form 1040). They are not subject to the 2%-of-adjusted-gross-income limit. To deduct these expenses, you must complete Form 2106 or 2106–EZ even if you meet the requirements described earlier under *Form not required.*

For more information on impairment-related work expenses, see Publication 463.

Recordkeeping

You must keep records as proof of any deduction claimed on your tax return. Generally, you should keep your records for 3 years from the date of filing the tax return and claiming the deduction.

If you are an employee who is reimbursed for expenses and you give your records and documentation to your employer, you do not have to keep duplicate copies of this information. However, you should keep your records for a 3-year period if:

1) You claim deductions for expenses that are more than your reimbursement,
2) Your employer does not use adequate accounting procedures to verify expense accounts,
3) You are related to your employer, or
4) Your expenses are reimbursed under a nonaccountable plan.

Examples of records to keep. If any of the above cases apply to you, you must be able to prove that your expenses are deductible. You should keep adequate records or have sufficient evidence that will support your expenses. Estimates or approximations do not qualify as proof of an expense. Some examples of what can be used to help prove your expenses are:

1) Documents, such as transcripts, course descriptions, catalogs, etc., showing periods of enrollment in educational institutions, principal subjects studied, and descriptions of educational activity.
2) Canceled checks and receipts to verify amounts you spent for:
   a) Tuition and books,
   b) Meals and lodging while away from home overnight for educational purposes,
   c) Travel and transportation, and
   d) Other educational expenses.
3) Statements from your employer explaining whether the education was necessary for you to keep your job, salary, or status; how the education helped maintain or improve skills needed in your job; how much reimbursement you received; and the type of certificate and subjects taught, if you are a teacher.
4) Complete information about any scholarship or fellowship grants, including amounts you received during the year.

Illustrated Example

Victor Jones teaches math at a private high school in North Carolina. He was selected to attend a 3-week math seminar at a university in California. The seminar will improve his skills in his current job and is qualifying work-related education. He was reimbursed for his expenses under his employer's nonaccountable plan, so his reimbursement of $2,100 is included in the wages shown in box 1 of his Form W–2. Victor will file Form 1040.

His actual expenses for the seminar are as follows:

Lodging	$1,050
Meals	526
Airfare	550
Taxi fares	50
Tuition and books	400
Total Expenses	$2,576

Victor files Form 2106–EZ with his tax return. He shows his expenses for the seminar in Part I of the form. He enters $1,650 ($1,050 + $550 + $50) on line 3 to account for his lodging, airfare, and taxi fares. He enters $400 on line 4 for his tuition and books. On the line for meals and entertainment expenses to the left of line 5, Victor enters $526 for meal expenses. He multiplies that amount by 50% and enters the result, $263, on line 5. On line 6, Victor totals the amounts from lines 3 through 5. He carries the total, $2,313, to line 20 of Schedule A (Form 1040).

Since he does not claim any vehicle expenses, Victor leaves Part II blank. His filled-in form is shown on the next page.

Form **2106-EZ**

Department of the Treasury
Internal Revenue Service

Unreimbursed Employee Business Expenses

► **Attach to Form 1040.**

OMB No. 1545-1441

2003

Attachment
Sequence No. **54A**

Your name	Occupation in which you incurred expenses	Social security number
Victor Jones	Teaching	123 : 00 : 4321

You May Use This Form Only if All of the Following Apply.

- You are an employee deducting ordinary and necessary expenses attributable to your job. An ordinary expense is one that is common and accepted in your field of trade, business, or profession. A necessary expense is one that is helpful and appropriate for your business. An expense does not have to be required to be considered necessary.
- You **do not** get reimbursed by your employer for any expenses (amounts your employer included in box 1 of your Form W-2 are not considered reimbursements).
- If you are claiming vehicle expense, you are using the standard mileage rate for 2003.

Caution: *You can use the standard mileage rate for 2003* ***only if: (a)*** *you owned the vehicle and used the standard mileage rate for the first year you placed the vehicle in service* ***or (b)*** *you leased the vehicle and used the standard mileage rate for the portion of the lease period after 1997.*

Part I **Figure Your Expenses**

		Line	Amount
1	Vehicle expense using the standard mileage rate. Complete Part II and multiply line 8a by 36¢ (.36)	1	
2	Parking fees, tolls, and transportation, including train, bus, etc., that **did not** involve overnight travel or commuting to and from work	2	
3	Travel expense while away from home overnight, including lodging, airplane, car rental, etc. **Do not** include meals and entertainment	3	1,650
4	Business expenses not included on lines 1 through 3. **Do not** include meals and entertainment	4	400
5	Meals and entertainment expenses: $ 526 x 50% (.50) (Employees subject to Department of Transportation (DOT) hours of service limits: Multiply meal expenses by 65% (.65) instead of 50%. For details, see instructions.)	5	263
6	**Total expenses.** Add lines 1 through 5. Enter here and **on line 20 of Schedule A (Form 1040).** (Fee-basis state or local government officials, qualified performing artists, and individuals with disabilities: See the instructions for special rules on where to enter this amount.)	6	2,313

Part II **Information on Your Vehicle.** Complete this part **only** if you are claiming vehicle expense on line 1.

7 When did you place your vehicle in service for business use? (month, day, year) ► ______ / ______ / ______

8 Of the total number of miles you drove your vehicle during 2003, enter the number of miles you used your vehicle for:

a Business ______ **b** Commuting ______ **c** Other ______

9 Do you (or your spouse) have another vehicle available for personal use? ☐ **Yes** ☐ **No**

10 Was your vehicle available for personal use during off-duty hours? ☐ **Yes** ☐ **No**

11a Do you have evidence to support your deduction? ☐ **Yes** ☐ **No**

b If "Yes," is the evidence written? ☐ **Yes** ☐ **No**

General Instructions

Section references are to the Internal Revenue Code.

A Change To Note

Standard mileage rate. The standard mileage rate is 36 cents for each mile of business use in 2003.

Purpose of Form

You may use Form 2106-EZ instead of Form 2106 to claim your unreimbursed employee business expenses if you meet all the requirements listed above Part I.

Recordkeeping

You cannot deduct expenses for travel (including meals, unless you used the standard meal allowance), entertainment, gifts, or use of a car or other listed property, unless you keep records to prove the time, place, business purpose, business relationship (for entertainment and gifts), and amounts of these expenses. Generally, you must also have receipts for all lodging expenses (regardless of the amount) and any other expense of $75 or more.

Additional Information

For more details about employee business expenses, see:

Pub. 463, Travel, Entertainment, Gift, and Car Expenses

Pub. 529, Miscellaneous Deductions

Pub. 587, Business Use of Your Home (Including Use by Daycare Providers)

Pub. 946, How To Depreciate Property

Specific Instructions

Part I—Figure Your Expenses

Line 2. See the line 8b instructions for the definition of commuting.

Line 3. Enter lodging and transportation expenses connected with overnight travel away from your tax home (defined on this page). You cannot deduct expenses for travel away from your tax home for any period of temporary employment of more than 1 year. **Do not** include expenses for meals and entertainment. For more details, including limits, see Pub. 463.

Instead of keeping records of your actual incidental expenses, you can use an **optional method for deducting incidental expenses only** if you did **not** pay or incur meal expenses on a day you were traveling away from your tax home. The amount of the deduction is $2 a day for the period from January 1 through October 31, 2003, and $3 a day for the period from November 1 through December 31, 2003. Incidental expenses include fees and tips given to porters, baggage carriers, bellhops, hotel maids, stewards or stewardesses and others on ships, and hotel servants in foreign countries. They do **not** include expenses for laundry, cleaning and pressing of clothing, lodging taxes, or the costs of telegrams or telephone calls. You cannot use this method on any day that you use the standard meal allowance (as explained in the instructions for line 5).

Generally, your **tax home** is your main place of business or post of duty regardless of where you maintain your family home. If you do not have a regular or main place of business because of the nature of your work, then your tax home is the place where you regularly live. If you do not fit in either of these categories, you are considered an itinerant and your tax home is wherever you work. As an itinerant, you are never away from home and cannot claim a travel expense deduction. For more details on your tax home, see Pub. 463.

Line 4. Enter other job-related expenses not listed on any other line of this form. Include

For Paperwork Reduction Act Notice, see back of form. Cat. No. 20604Q Form **2106-EZ** (2003)

13.

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

To contact your Taxpayer Advocate:

- Call the Taxpayer Advocate at **1–877–777–4778**.
- Call, write, or fax the Taxpayer Advocate office in your area.
- Call **1–800–829–4059** if you are a TTY/TDD user.
- Visit the web site at **www.irs.gov/advocate**.

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.

Internet. You can access the IRS website 24 hours a day, 7 days a week at **www.irs.gov** to:

- ***E-file.*** Access commercial tax preparation and *e-file* services available for free to eligible taxpayers.
- Check the amount of advance child tax credit payments you received in 2003.
- Check the status of your 2003 refund. Click on “Where’s My Refund” and then on “Go Get My Refund Status.” Be sure to wait at least 6 weeks from the date you filed your return (3 weeks if you filed electronically) and have your 2003 tax return available because you will need to know your filing status and the exact whole dollar amount of your refund.
- Download forms, instructions, and publications.
- Order IRS products on-line.
- See answers to frequently asked tax questions.
- Search publications on-line by topic or keyword.
- Figure your withholding allowances using our Form W-4 calculator.
- Send us comments or request help by email.
- Sign up to receive local and national tax news by email.
- 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**.

Fax. You can get over 100 of the most requested forms and instructions 24 hours a day, 7 days a week, by fax. Just call **703–368–9694** from your fax machine. 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**.

Long-distance charges may apply.

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 and prior-year forms and instructions. You should receive your order within 10 days.
- *Asking tax questions.* Call the IRS with your tax questions at **1–800–829–1040.**
- *Solving problems.* You can get face-to-face help solving tax problems every business day in IRS Taxpayer Assistance Centers. An employee can explain IRS letters, request adjustments to your account, or help you set up a payment plan. Call your local Taxpayer Assistance Center for an appointment. To find the number, go to **www.irs.gov** or look in the phone book under “United States Government, Internal Revenue Service.”
- *TTY/TDD equipment.* If you have access to TTY/TDD equipment, call **1–800–829–4059** to ask tax or account questions or to order forms and publications.
- *TeleTax topics.* Call **1–800–829–4477** to listen to pre-recorded messages covering various tax topics.
- *Refund information.* If you would like to check the status of your 2003 refund, call **1–800–829–4477** for automated refund information and follow the recorded instructions or call **1–800–829–1954**. Be sure to wait at least 6 weeks from the date you filed your return (3 weeks if you filed electronically) and have your 2003 tax return available because you will need to know your filing status and the exact whole dollar amount of your refund.

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

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

- *Products.* You can walk in to many post offices, libraries, and IRS offices to pick up certain forms, instructions, and publications. Some IRS offices, libraries, grocery stores, copy centers, city and county governments, credit unions, and office supply stores have a collection of products available to print from a CD-ROM or photocopy from reproducible proofs. Also, some IRS offices and libraries have the Internal Revenue Code, regulations, Internal Revenue Bulletins, and Cumulative Bulletins available for research purposes.
- *Services.* You can walk in to your local Taxpayer Assistance Center every business day to ask tax questions or get help with a tax problem. An employee can explain IRS letters, request adjustments to your account, or help you set up a payment plan. You can set up an appointment by calling your local Center and, at the prompt, leaving a message requesting Everyday Tax Solutions help. A representative will call you back within 2 business days to schedule an in-person appointment at your convenience. To find the number, go to **www.irs.gov** or look in the phone book under "United States Government, Internal Revenue Service."

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. Use the address that applies to your part of the country.

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

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

- Current tax forms, instructions, and publications.
- Prior-year tax forms and instructions.
- Frequently requested tax forms that may be filled in electronically, printed out for submission, and saved for recordkeeping.
- Internal Revenue Bulletins.

Buy the CD-ROM from National Technical Information Service (NTIS) on the Internet at **www.irs.gov/cdorders** for $22 (no handling fee) or call **1–877–233–6767** toll free to buy the CD-ROM for $22 (plus a $5 handling fee). The first release is available in early January and the final release is available in late February.

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

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

Appendices

The following appendices include an illustrated example of how to use the Form 8863 when claiming both the Hope and lifetime learning (education) credits at the same time and a chart reflecting some of the major differences between the many tax benefits for 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 2003.
2) **Appendix B** — A chart summarizing ***some*** of the differences between the education tax benefits discussed in this publication. It is intended only as a guide. Look in this publication for more complete information.

Appendix A. Illustrated Example of Education Credits

Dave and Valerie Jones are married and file a joint tax return. For 2003, they claim exemptions for their two dependent children on their tax return. Their modified adjusted gross income is $86,000. Their tax, before credits, is $9,701. Their son, Sean, will receive his bachelor's degree in psychology from the state college in May 2004. Their daughter, Corey, enrolled full-time at that same college in August 2002 to begin working on her bachelor's degree in physical education. In July 2003, Dave and Valerie paid $2,200 in tuition costs for each child for the Fall 2003 semester. In December 2003, they also paid $2,600 of tuition for each child for the Spring 2004 semester that begins in January.

Dave and Valerie, their children, and the college meet all of the requirements for the 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 2003 for academic periods beginning in 2003 and the first 3 months of 2004 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 2003 for academic periods beginning in 2003 and January 2004 qualify for the Hope credit.

Dave and Valerie figure their tentative education credits for 2003, $2,460, as shown in the completed Form 8863. They cannot claim the full amount because their modified adjusted gross income is more than $83,000. They carry the amount from line 18 of Form 8863 to line 47 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.
▶ Attach to Form 1040 or Form 1040A.

OMB No. 1545-1618
2003
Attachment Sequence No. **50**

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

Caution: *You **cannot** take both an education credit and the tuition and fees deduction (Form 1040, line 26, or Form 1040A, line 19) for the **same student** in the same year.*

Part I Hope Credit. Caution: *You **cannot** take the Hope credit for more than **2** tax years for the **same student.***

1

(a) Student's name (as shown on page 1 of your tax return) First name / Last name	(b) Student's social security number (as shown on page 1 of your tax return)	(c) Qualified expenses (see instructions). **Do not** enter more than $2,000 for each student.	(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). If you are taking the lifetime learning credit for another student, go to Part II; otherwise, go to Part III ▶	3	1,500		

Part II Lifetime Learning Credit

4

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

(a) Student's name (as shown on page 1 of your tax return) First name	Last name	(b) Student's social security number (as shown on page 1 of your tax return)	(c) Qualified expenses (see instructions)
Sean	Jones	246 00 9731	4,800

5 Add the amounts on line 4, column (c), and enter the total	5	4,800
6 Enter the **smaller** of line 5 or $10,000	6	4,800
7 Tentative lifetime learning credit. Multiply line 6 by 20% (.20) and go to Part III . . . ▶	7	960

Part III Allowable Education Credits

8 Tentative education credits. Add lines 3 and 7			8	2,460
9 Enter: $103,000 if married filing jointly; $51,000 if single, head of household, or qualifying widow(er)	9	103,000		
10 Enter the amount from Form 1040, line 35*, or Form 1040A, line 22 .	10	86,000		
11 Subtract line 10 from line 9. If zero or less, **stop;** you cannot take any education credits	11	17,000		
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	× . 850
14 Multiply line 8 by line 13 . . . . ▶			14	2,091
15 Enter the amount from Form 1040, line 43, or Form 1040A, line 28			15	9,701
16 Enter the total, if any, of your credits from Form 1040, lines 44 through 46, or Form 1040A, lines 29 and 30			16	0
17 Subtract line 16 from line 15. If zero or less, **stop;** you cannot take any education credits . . . . ▶			17	9,701
18 **Education credits.** Enter the **smaller** of line 14 or line 17 here and on Form 1040, line 47, or Form 1040A, line 31 . . . . ▶			18	2,091

*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.

Appendix B — Highlights of Tax Benefits for Education for Tax Year 2003

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.*

	Scholarships, Fellowships, Grants, and Tuition Reductions	**Hope Credit**	**Lifetime Learning Credit**	**Student Loan Interest Deduction**	**Tuition and Fees Deduction**
What is your benefit?	Amounts received may not be taxable	Credits can reduce amount of tax you must pay		Can deduct interest paid	Can deduct expenses
What is the annual limit?	None	$1,500 credit per student	$2,000 credit per family	$2,500 deduction	$3,000 deduction
What expenses qualify besides tuition and required enrollment fees?	None	None	None	Books Supplies Equipment Room & board Transportation Other necessary expenses	None
What education qualifies?	Undergraduate & graduate K – 12	1st 2 years of undergraduate (postsecondary)	Undergraduate & graduate Courses to acquire or improve job skills	Undergraduate & graduate	Undergraduate & graduate
What are some of the other conditions that apply?	Must be in degree or vocational program Payment of tuition and required fees must be allowed under the grant	Can be claimed for only 2 tax years Must be enrolled at least half-time in degree program No felony drug conviction(s)		Must have been at least half-time student in degree program	Cannot claim both deduction & education credit for same student in same year
In what income range do benefits phase out?	No phaseout	$41,000 – $51,000 $83,000 – $103,000 for joint returns		$50,000 – $65,000 $100,000 – $130,000 for joint returns	No deduction if income is more than $65,000 ($130,000 for joint returns)

(Continued)

Appendix B *(Continued)*

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.*

	Coverdell ESA[1]	**Qualified Tuition Program (QTP)[1]**	**Early IRA Distributions[1]**	**Education Savings Bond Program[1]**	**Employer-Provided Educational Assistance[1]**	**Business Deduction for Work-Related Education**
What is your benefit?	Earnings not taxed	Earnings not taxed[2]	No 10% additional tax on early distribution	Interest not taxed	Employer benefits not taxed	Can deduct expenses
What is the annual limit?	$2,000 contribution per beneficiary	None	Amount of qualified education expenses	Amount of qualified education expenses	$5,250 exclusion	Amount of qualifying work-related education expenses
What expenses qualify besides tuition and required enrollment fees?	Books Supplies Equipment Expenses for special needs services Payments to QTP Higher education: Room & board if at least half-time student Elem/sec (K–12) education: Tutoring Room & board Uniforms Transportation Computer access Supplementary expenses	Books Supplies Equipment Room & board if at least half-time student Expenses for special needs services	Books Supplies Equipment Room & board if at least half-time student Expenses for special needs services	Payments to Coverdell ESA Payments to QTP	Books Supplies Equipment	Transportation Travel Other necessary expenses
What education qualifies?	Undergraduate & graduate K–12	Undergraduate & graduate	Undergraduate & graduate	Undergraduate & graduate	Undergraduate & graduate	Required by employer or law to keep present job, salary, status Maintain or improve job skills
What are some of the other conditions that apply?	Assets must be distributed at age 30 unless special needs beneficiary			Applies only to qualified series EE bonds issued after 1989 or series I bonds		Cannot be to meet minimum educational requirements of present trade/ business Cannot qualify you for new trade/ business
In what income range do benefits phase out?	$95,000 – $110,000 $190,000 – $220,000 for joint returns	No phaseout	No phaseout	$58,500 – $73,500 $87,750 – $117,750 for joint returns	No phaseout	May be subject to limit on itemized deductions

[1] Any nontaxable distribution is limited to the amount that does not exceed qualified education expenses.
[2] Does not apply to distributions from QTPs sponsored by educational institution until 1/1/04; however, no 10% additional tax is imposed.

Index

To help us develop a more useful index, please let us know if you have ideas for index entries. See “Comments and Suggestions” in the “Introduction” for the ways you can reach us.

■