GFG
College Financing Insights

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Paying For College

How to Receive $10,000 in Education Tax Credits and WIPE-OUT $5,834 in Capital Gains Tax!!

Wipe Out $28,000 In Capital Gains In Your Kid's Account and Save $5834 *EACH YEAR* in Capital Gains Tax

Many families simply earn too much for their child to qualify for need-based college aid, so they need to shift their focus to what I call tax aid or IRS Scholarships; these tax savings that help lower the overall cost of college. I know it is not a sexy or instantly gratifying as a scholarship, but the whole idea of college financial planning is to keep as much money in your pocket and the money is the same whether it comes from scholarships or tax savings! With this strategy, parents can wipe out $28,000 in capital gains and save $5834 *each year* while a child is in college. That’s a pretty good way to save for college, and it can pay dividends in retirement, too.

In the following hypothetical example you will gift your daughter appreciated stock or other investments like mutual funds or ETFs, and your daughter will use the standard deduction, personal exemption and American Opportunity Tax Credit to offset $28,000 of long-term capital gains in a single year.

Standard Deduction and Personal Exemption

Typically parents will claim the $4,050 personal exemption for their child because the parents are providing greater than half of the child’s support throughout the year. However, during the college years, if your daughter uses her own income and assets to provide more than half of her own support (roughly half the total cost of college), then she would also be able to claim the personal exemption of $4,050 (for 2016) for herself, instead of you (the parent) claiming it. Now I know what you are thinking, why would I want to do that if it can save ME money on my taxes? After all the parents are in the higher tax bracket and would save more money right? Well hold on and I will explain it to you.

The standard deduction (for 2016) for a dependent child (i.e. parents claim the personal exemption for the child), is the child’s earned income +$300 up to the maximum of $6,300. However, if you child is claiming the personal exemption for herself (i.e. passed the support test), then she can automatically claim the personal exemption *and* the full standard deduction of $6,300, regardless of earned income.

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American Opportunity Tax Credit

Furthermore, as long as you *do not* claim the AOTC on your tax return, and *do not* claim your daughter as a personal exemption, she can claim the AOTC on her tax return.

The AOTC is worth up to $2,500 per student for four academic years. The income phase-out is $160,000 – $180,000 of modified adjusted gross income on joint tax returns. The amount of the credit is calculated as 100% of the first $2,000 in qualified tuition and fees costs paid, plus 25% of the next $2,000 paid for such fees.

2016 Kiddie Tax

The kiddie tax is a tax on unearned income paid to minors. For 2016, the first $1,050 of such income is tax free, the second $1,050 is taxed to the child at his/her tax rate and all unearned income over $2,100 is taxed at the parents' tax rate. The kiddie tax rule now applies to children under age 19 and full-time college students under the age of 24.

In 2016, the only way that college students under age 24 will be able to avoid the kiddie tax is if they provide over half of their own support from their own earned income (i.e., wages and salaries, not income from selling stocks). *Notice that this is different from the support test for the personal exemption mentioned above which allows the student to use their earned income in addition to their unearned income and personal assets to pass the test.*

Tax Saving Example

Let's assume that you have been gifting your daughter appreciated assets ($14,000 per year, per donor permitted in 2016; $28,000 on joint return) over the years and your daughter will sell the investment during her first year of college, realizing $28,000 in long-term capital gains. *Note: the $28,000 in realized gains has nothing to do with the $28,000 annual exclusion on a joint tax return*. To make it clearer, assume she has $78,000 in her account and only invested $50,000, thus she has a $28,000 long-term capital gain. She will have to pay tax on this $28,000 gain when she sells. She will then use the proceeds from the sale of assets to pay to enroll at a university with a total cost of attendance of $50,000 per year.

She will be able to take advantage of the standard deduction, personal exemption and the American Opportunity Tax Credit to offset her $26,000 of unearned (long-term capital gains) each year.

The standard deduction and personal exemption (see above) will reduce her capital gain income of $28,000 ($26,000 – $4,050 – $6,300 = $16,650), leaving a remaining taxable income of $16,650 that is taxed at the parent's capital gain tax rate of 15%, for a total tax of $2,498.

Her overall federal tax of $2,498 will be eliminated by the American Opportunity Tax Credit (see the math below).

Long-term capital gains $28,000

Student's personal exemption –$4,050

Student's standard deduction (single) –$6,300

Net taxable income $16,650

Capital gains rate (parents' rate of 15%) x 0.15

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Gross federal tax = $2,498

American Opportunity Tax Credit ($2,500)

Federal tax due $0

For clients in the highest tax bracket who are subject to the 3.8% net investment income surtax, the capital gains tax would be 23.8%, or $6,664 per year on $28,000 in gains. The child's tax would be $830 (20% x $16,650 = $3,330 – $2,500 AOTC = $830; and the 3.8% surtax would not apply to the child), thus saving the family $5,834 per year in taxes; $23,336 over four years of college, even under kiddie tax rules. Even with a modest rate of return, the $23,336 in tax savings should grow to $50,000 by the time most parents reach retirement age. This underscores my longstanding philosophy that college planning is retirement planning.

Financial Aid Planning Note: *This strategy is primarily intended for college students who do not qualify for need-based college aid. By shifting assets into the child's name, the child's Expected Family Contribution (EFC) toward the cost of college will increase by 20-25% of the value of the assets in the child's name (depending on which aid formula is being used Federal or Institutional; under the Consensus formula, assets are treated at 5% regardless of who the owner is, the parents or student). The resulting increase in the student's EFC may or may not decrease the student's need-based financial aid eligibility.*

Get $10,000 Per Child In College Tax Credits, Thanks To New Tax Deal

The new tax deal has given the $2,500 a year American Opportunity Tax Credit (AOTC) permanent life instead of expiring at the end of 2017. The credit reduces your federal tax bill dollar-for-dollar up to $2,500 per year for each eligible college student for whom you pay qualified tuition expenses. It can be used only for undergraduates and for a maximum of four years—that's a $10,000 tax subsidy. And if you have more than one child in college at the same time, you can claim more than one credit.

This break had been set to expire at the end of 2017 but the new (December 2015) tax deal makes the credit permanently available, and that is good news for parents trying to pay for the high cost of college. The tax deal also made computers, iPads and tablets a qualified expense under 529 college savings plan rules, meaning you can use 529 plan money tax free and without penalty to buy the aforementioned devices.

The American Opportunity Tax Credit is worth more than the older college-related tax credits you might be familiar with: the Hope Scholarship and Lifetime Learning Credits. It's also more valuable than another education tax break, the tuition and fees deduction. But understandably, with all of those education credits, there is a lot of confusion causing some to miss out and even worse, some to misuse them and get a nasty letter from the IRS. Because there are so many education tax breaks and so many if's, ands and buts, they are the most widely misunderstood and misused tax deductions and credits. Most CPA's and tax attorneys need to read up on all the complexities before they apply the breaks for their clients.

Which College Credit Should You Claim?

There are two college-related tax credits, the American Opportunity Tax Credit and the Lifetime Learning Credit, as well as one deduction, the tuition and fees deduction. The *credit* reduces your tax liability dollar for dollar while the deduction reduces your taxable income thus making credits more valuable. For example, if you owe $2,500 in tax, the $2,500 AOTC reduces that liability to 0. And even better, if you owe less than $2,500, up to $1,000 of the AOTC is refundable, meaning you can collect the money as a refund. (The credit is not refundable on a dependent child's return) If your taxable income is $50,000 the Tuition and Fees Deduction will reduce your taxable income by a maximum of $4,000. Essentially, you would lower your tax liability before other credits, from *roughly* $6581 to $5981, a savings of $600.You may only claim one credit or deduction per child in any given year. However, you may apply the same credit or deduction to each child. The American Opportunity Tax Credit (AOTC) is the logical choice for full-time undergraduates because it is by far the richest at up to $2,500 per eligible child, versus $2,000 for the Lifetime credit. Essentially, AOTC took what was previously called the Hope Credit and made it worth more, and made it available to more families. There is, however, still reason to use the Lifetime Learning Credit, since it is available for part-time and graduate study while the AOTC is only for undergraduates.

American Opportunity Tax Credit Income Phase-Out

The AOTC is worth up to $2,500 per student each year for four academic years (extended through the 2017 tax year). But families who earn too much can't claim the credit. The income phase-out for claiming the AOTC is $160,000 – $180,000 of modified adjusted gross income on joint tax returns ($80,000 – $90,000 for single tax filers and head of household). The amount of the credit is calculated as 100% of the first $2,000 in qualified tuition and fees costs paid, plus 25% of the next $2,000 paid for such fees.

Which College Expenses Count?

According to IRS Publication 970, *qualified education expenses* are tuition and related expenses required for enrollment or attendance at an eligible educational institution. Curiously, Room and Board are NOT qualified education expenses.

An *eligible educational institution* is any college, university, vocational school, or other post-secondary educational institution eligible to participate in a student aid program administered by the Department of Education. It includes virtually all accredited public, non-profit, and proprietary (privately owned profit-making) post-secondary institutions. The credit cannot be claimed for college credits taken under dual enrollment programs, where high school students are simultaneously enrolled in college courses. The reason for this is because, according to the Department of Education, high school students are not technically enrolled in a degree-granting program because they do not yet have a high school diploma, even though they are earning college credits. It doesn't make any sense, but that is the rule.

Related expenses are student-activity fees and expenses for course-related books, supplies, and equipment that are required as a condition of enrollment or attendance. Now here is the tricky part: the amount of qualified educational expenses that can be used in calculating these tax credits is reduced if you pay for the qualified expenses with certain tax-free funds. They include:

- Tax-free portions of scholarships and fellowships
- Pell grants
- Employer-provided educational assistance (section 127 tuition reimbursement plan)
- Veterans' educational assistance
- Any other tax-free payments received as educational assistance
- Tax Free distributions of 529 Plan or Education IRA's

Claiming the AOTC Takes Coordination

It is very important to remember that you cannot claim any of the college tax credits, including the AOTC, based on expenses that were used to calculate the tax-free portion of a distribution from a 529 college savings or prepaid plan, or a Coverdell Education Savings Account (ESA). The AOTC may be claimed in the same year that a tax-free distribution is made as long as the same expenses are not used to calculate the tax-free distribution AND the American Opportunity Tax Credit.

For example, if your tuition and other qualified expenses are $18,000 and you take $12,000 out of a 529 college savings plan to pay for tuition you cannot use that $12,000 of tuition expenses to claim the American Opportunity Tax Credit also. You CAN use the next $6,000 of the expenses to claim the AOTC. You may NOT claim another education tax break, tuition and fees deduction or Lifetime credit for this child even though they still have "leftover" expenses. This will certainly be frowned upon by the IRS.

This coordination of benefits provision is exactly why it helps to have a tax preparer or a college financial specialist work with your preparer , who understands education funding so that you can make the most of the benefits that you qualify for. Even more important, however, is to discuss how you will pay for college ahead of time with a financial planning or tax professional so that you can coordinate how to best pay for college using the income and assets that you have, and still be eligible to claim the full amount of college tax credit that you are eligible for.

Confused? Most people are which is why you need an expert to coordinate these tax breaks in order to 1) get the most benefit 2) So you do not run afoul of the IRS. If you need assistance please e-mail me.

If You Make Too Much Money To Qualify For The Credit, Try This

If you are not able to claim the AOTC because your income exceeds the $180,000 (MAGI) phase-out threshold, maybe your child can claim the credit on his or her tax return. If you cannot, or do not claim the AOTC (or any other tax credit or the tuition and fees deduction), and you also do not claim that child as a personal exemption on your tax return, your child can claim the American Opportunity Tax Credit on his or her tax return. For more on how to use the AOTC, standard deduction and personal exemption on your child's tax return, to minimize or eliminate thousands of dollars of earned and unearned income, I detail it here.

The American Opportunity Tax Credit Does Not Impact College Financial Aid

When calculating a student's expected family contribution (EFC)(click link to read a detailed explanation of what EFC is and how to get maximum amount of financial aid) toward the cost of college, the federal, state and withholding taxes that parents and students pay reduce the amount of their incomes that counts against them in the aid calculation. Since the AOTC reduces the federal income tax paid by parents (or whomever the taxpayer is), and therefore reduces the amount of tax allowances they have against their income in the aid formula, the credit would normally increase the student's expected family contribution and decrease the student's aid eligibility. However, the financial aid forms, the FAFSA and the CSS Profile, effectively "add back" the amount of the credit that parents claim on their tax return, thereby eliminating any negative impact on the student's potential need-based aid eligibility.

Well, that's it. I hope his helps. If you have any questions or would like to discuss your individual situation please feel free to shoot me an e-mail or call me.

Until Next Time….

Best Wishes,
Michael Gaer

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