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## Notices

### **Notice 97-60, 1997-2 CB 310, 10/27/1997, IRC Sec(s). 25A**

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## **Higher education tax incentives.**

### **Headnote:**







IRS has provided guidance, in Q&A format, on higher education tax incentives recently enacted by Taxpayer Relief Act of '97, P.L. 105-34, 8/5/97. Provisions discussed are: Hope Scholarship Credit and Lifetime Learning Credit, established under Code Sec. 25A; ; student loan interest deduction under Code Sec. 221; ; and, education IRAs under Code Sec. 530; . Several other '97 law changes to existing IRC sections were also discussed.

**Reference(s):** ¶ 25A4; ¶ 2214; ¶ 5304; Code Sec. 25A; Code Sec. 221; Code Sec. 530;

### **Full Text:**

### **Purpose**

The questions and answers contained in this notice provide guidance on the higher education tax incentives recently enacted by the Taxpayer Relief Act of 1997 (Pub. L. No. 105-34, 111

Stat. 788) (TRA '97). Specifically, TRA '97 added  section 25A of the Internal Revenue Code providing the Hope Scholarship Credit and Lifetime Learning Credit,  section 221 providing a deduction for student loan interest, and  section 530 creating Education Individual Retirement Accounts (“Education IRAs”). TRA '97 also amended  section 72(t) eliminating the early withdrawal tax on certain IRA withdrawals,  section 127 providing an exclusion from income for employer-provided educational assistance, and  section 529 setting the requirements for tax-exempt status for qualified state tuition programs (QSTPs).

These provisions create several new tax benefits for families who are saving for, or already paying, higher education costs or are repaying student loans. In addition, TRA '97 extends the exclusion for employer-provided educational assistance and makes the rules for qualified state tuition programs more flexible. The following discussion reviews in greater detail the requirements for each of these benefits. Whether a taxpayer may take advantage of these benefits depends on the taxpayer's individual facts and circumstances.

## Discussion

### 1. The Hope Scholarship Credit

Beginning January 1, 1998, taxpayers may be eligible to claim a nonrefundable Hope Scholarship Credit against their federal income taxes. The Hope Scholarship Credit may be claimed for the qualified tuition and related expenses of EACH student in the taxpayer's family (i.e., the taxpayer, the taxpayer's spouse, or an eligible dependent) who is enrolled at least half-time in one of the first two years of postsecondary education and who is enrolled in a program leading to a degree, certificate, or other recognized educational credential. The amount that may be claimed as a credit is generally equal to: (1) 100 percent off the first \$1,000 of the taxpayer's out-of-pocket expenses for each student's qualified tuition and related expenses, plus (2) 50 percent of the next \$1,000 of the taxpayer's out-of-pocket expenses for each student's qualified tuition and related expenses. Thus, the maximum credit a taxpayer may claim for a taxable year is \$1,500 multiplied by the number of students in the family who meet the enrollment criteria described above.

The amount a taxpayer may claim as a Hope Scholarship Credit is gradually reduced for taxpayers who have modified adjusted gross income between \$40,000 (\$80,000 for married taxpayers filing jointly) and \$50,000 (\$100,000 for married taxpayers filing jointly). Taxpayers with modified adjusted gross income over \$50,000 (\$100,000 for married taxpayers filing jointly) may not claim the Hope Scholarship Credit. Both the dollar limitation on the expenses for which the credit may be claimed and the modified adjusted gross income limitation will be indexed for inflation in 2002 and years thereafter.

The Hope Scholarship Credit may be claimed for payments of qualified tuition and related expenses made on or after January 1, 1998, for academic periods beginning on or after January 1, 1998. Therefore, the first time taxpayers will be able to claim the credit is when they file their 1998 tax returns in 1999. The Hope Scholarship Credit is not available for any amount paid in 1997.

Q1: Who may claim the Hope Scholarship Credit?

A1: An individual paying qualified tuition and related expenses at a postsecondary educational institution may claim the credit, provided the student whose expenses are being paid and the institution meet certain eligibility requirements.

Q2: May an individual claim a Hope Scholarship Credit for paying qualified tuition and related expenses for other family members?

A2: Yes. An individual may claim the credit for his/her own qualified tuition and related expenses and the qualified tuition and related expenses of his/her spouse and other eligible dependents (including children) for whom the dependency exemption is claimed. Generally, a parent may claim the dependency exemption for his/her unmarried child if: (1) the parent supplies more than half the child's support for the taxable year, and (2) the child is under age 19 or is a full-time student under age 24.

Q3: What are the eligibility requirements for the student?

A3: A student is eligible for the Hope Scholarship Credit if: (1) for at least one academic period (e.g., semester, trimester, quarter) beginning during the calendar year, the student is enrolled at least half-time in a program leading to a degree, certificate, or other recognized educational credential and is enrolled in one of the first two years of postsecondary education, and (2) the student is free of any conviction for a Federal or State felony offense consisting of the possession or distribution of a controlled substance. For purposes of the Hope Scholarship Credit, a student will be considered to be enrolled at least half-time if the student is enrolled for at least half the full-time academic workload for the course of study the student is pursuing as determined under the standards of the institution where the student is enrolled. The institution's standard for a full-time workload must equal or exceed the standards established by the Department of Education under the Higher Education Act and set forth in 34 C.F.R. section 674.2(b).

Q4: What are the eligibility requirements for the institution?

A4: The college, university, vocational school, or other postsecondary educational institution where the student is enrolled must be an institution that is described in section 481 of the

Higher Education Act of 1965 (20 U.S.C. 1088) and, therefore, eligible to participate in the student aid programs administered by the Department of Education. This category includes virtually all accredited public, nonprofit, and proprietary postsecondary institutions. (The same eligibility requirements for institutions apply for the Lifetime Learning Credit, described in the next section.)

Q5: The Hope Scholarship Credit may be claimed only for amounts spent on “qualified tuition and related expenses.” Which expenses are included in qualified tuition and related expenses?

A5: The term “qualified tuition and related expenses” means the tuition and fees an individual is required to pay in order to be enrolled at or attend an eligible institution. Amounts paid for any course or other education involving sports, games, or hobbies are not eligible for the credit, unless the course or other education is part of the student's degree program. Charges and fees associated with room, board, student activities, athletics, insurance, books, equipment, transportation, and similar personal, living, or family expenses are not qualified tuition or related expenses. (The same definition of “qualified tuition and related expenses” applies for the Lifetime Learning Credit, described in the next section.)


Q6: The Hope Scholarship Credit is available only if a taxpayer's “modified adjusted gross income” is below a specified amount. How does a taxpayer know what his/her modified adjusted gross income is?

A6: For most taxpayers, modified adjusted gross income is the same as adjusted gross income. Taxpayers compute adjusted gross income as part of completing a Federal income tax return. For those few taxpayers who earn income abroad or receive income from certain American territories or possessions, modified adjusted gross income will be greater than adjusted gross income. In those cases, the individual's adjusted gross income will be increased by: (1) certain amounts that the individual earns abroad, (2) amounts effectively connected with the individual's conduct of a trade or business or derived from sources in Guam, American Samoa, or the Northern Mariana Islands (if the individual is a resident of the possession where the source of the income is located), and (3) amounts derived from sources in Puerto Rico (if the individual is a Puerto Rican resident). (The same rules apply for the Lifetime Learning Credit, described in the next section.)

Q7: May a nonresident alien claim the Hope Scholarship Credit?

A7: Generally no. There is an exception for certain nonresident aliens who are married to U.S. citizens or resident aliens. Nonresident aliens should consult a U.S. tax advisor to determine whether the exception applies to them. (The same rules apply to the Lifetime Learning Credit, described in the next section.)

Q8: Are qualified tuition and related expenses for graduate-level degree work eligible for the Hope Scholarship Credit?

A8: No. However, the Lifetime Learning Credit is available for these expenses (See  Sec. 2, Q&A5.)

Q9: May an individual claim a Hope Scholarship Credit for more than one family member?

A9: Yes. Furthermore, the credit is calculated on a per student, rather than a per family, basis. For example, if an individual whose modified adjusted gross income is \$35,000 pays over \$2,000 in qualified tuition and related expenses for himself and over \$2,000 in qualified tuition and related expenses for his dependent child, and both he and his dependent child meet the eligibility requirements, the individual may claim a Hope Scholarship Credit of \$3,000 (i.e., a credit of \$1,500 for his expenses plus a credit of \$1,500 for his child's expenses).

Q10: May both the parent and a dependent child claim the Hope Scholarship Credit for the child's qualified tuition and related expenses in the same year?

A10: No. Either the parent or the child, but not both, may claim the credit for the child's expenses in a particular year. If an individual claims the child as a dependent on his/her Federal income tax return for the year, only the individual may claim the Hope Scholarship Credit for the child's qualified tuition and related expenses. If no one claims the child as a dependent on a Federal income tax return for the year, only the child may claim the Hope Scholarship Credit for the child's expenses. (The same rules relating to individuals and dependents apply for the Lifetime Learning Credit, described in the next section.)

Q11: If a married taxpayer files a separate return, may the taxpayer claim a Hope Scholarship Credit on his/her income tax return?

A11: No. Married taxpayers may claim the credit only if the taxpayer and the taxpayer's spouse file a joint return for the taxable year. (The same rules apply for the Lifetime Learning Credit, described in the next section.)

Q12: How does a parent claim a Hope Scholarship Credit for the qualified tuition and related expenses of a dependent child?

A12: The parent may claim the credit on his/her tax return even if the child files his/her own tax return. When a child is claimed as a dependent on a parent's return, any qualified tuition or related expenses paid by the child during the year are treated as if the parent had paid them. Therefore, these expenses are included in calculating the parent's Hope Scholarship Credit. A child may not claim a Hope Scholarship Credit on his/her tax return for a particular year if the

child's parent claims the child as a dependent in that same year. (The same rules apply for the Lifetime Learning Credit, described in the next section.)

Q13: What is the maximum Hope Scholarship Credit a taxpayer may claim for an eligible student?

A13: Until 2002 (when the dollar limitations are indexed for inflation), for each student who meets the eligibility requirements, the credit amount is 100 percent of the first \$1,000 of the taxpayer's out-of-pocket expenses for qualified tuition and related expenses, plus 50 percent of the next \$1,000 of the taxpayers out-of-pocket expenses for qualified tuition and related expenses. Therefore, the maximum credit amount for the expenses of an eligible student is \$1,500. If the taxpayer is claiming a credit for more than one person, the credit amount for each student in the taxpayer's family is added together to determine the maximum total credit the taxpayer may claim.

Q14: The amount a taxpayer may claim as a Hope Scholarship Credit is gradually reduced for taxpayers with modified adjusted gross income between \$40,000 and \$50,000 (between \$80,000 and \$100,000 for married taxpayers filing jointly). How does this reduction work?

A14: The reduction works on a sliding scale that reflects where the taxpayer's modified adjusted gross income is in the phase-out range. For example, until 2002 (when the dollar limitations on the credit and the income ranges are indexed for inflation), if an eligible student (who is not anyone's dependent for tax purposes) pays \$2,000 or more in qualified tuition and related expenses in a particular year, and the student's modified adjusted gross income for the year is \$45,000 (half way along the \$10,000 phase-out range), the credit amount for the student is limited to \$750. By contrast, if the same student's modified adjusted gross income was \$35,000, the credit amount for the student would be the maximum \$1,500.

Q15: How does a taxpayer claim the Hope Scholarship Credit?

A15: The first year that the credit will be available is 1998. Thus, taxpayers will not be able to claim the credit until they file their 1998 tax returns in 1999. Instructions accompanying the 1998 tax forms (for returns required to be filed in 1999) will explain how to calculate the credit and how to claim it on the tax return.

Q16: Is there a limit to the number of times a taxpayer may claim the Hope Scholarship Credit for each student?

A16: Yes. The credit may be claimed in no more than two years for each student. Thus, for example, a couple with a child who starts as a freshman in the fall of 1998, continues as a sophomore in 1999, and meets the eligibility requirements may claim the credit for their child's

expenses in 1998 and again in 1999. After 1999, neither the parents, the student, nor anyone else may claim any additional Hope Scholarship Credits for this student's qualified tuition and related expenses. However, in 2000 and thereafter, the Lifetime Learning Credit may be available for this child's expenses. Furthermore, if the couple has another child who starts as a freshman in the fall of 1999, the couple may claim the Hope Scholarship Credit for that child's expenses in 1999 and one additional year.

Q17: May an individual claim both the Hope Scholarship Credit and the Lifetime Learning Credit for a student's expenses in a single taxable year?

A17: No. For each year in which a student meets the eligibility requirements for the Hope Scholarship Credit, the student's expenses may be used as the basis for a Hope Scholarship Credit or a Lifetime Learning Credit, but not both. If, for example, an eligible student pays more than \$2,000 in qualified tuition and related expenses during the calendar year, the student (or the individual claiming the student as a dependent) may not claim the Hope Scholarship Credit for the first \$2,000 of expenses and the Lifetime Learning Credit for the rest.

Q18: If a couple has two children, one who is a freshman and one who is a junior, may the couple claim a Hope Scholarship Credit for the freshman's expenses and a Lifetime Learning Credit for the junior's expenses?

A18: Yes. Assuming the applicable eligibility requirements have been met for each credit, a taxpayer may claim the Hope Scholarship Credit for one student's expenses and the Lifetime Learning Credit for another student's expenses in the same year.

Q19: May a parent or student claim a Hope Scholarship Credit for tuition paid in advance of when the academic period begins?

A19: Generally, the credit is available only for payments of qualified tuition and related expenses that cover an academic period beginning in the same calendar year as the payment is made. (An academic period begins on the first day of classes, and does not include periods of orientation, counseling, or vacation.) An exception, however, allows a parent or student to claim a Hope Scholarship Credit for payments of qualified tuition and related expenses made during the calendar year to cover an academic period that begins in January, February, or March of the following taxable year. BECAUSE THE HOPE SCHOLARSHIP CREDIT DOES NOT APPLY TO EXPENSES PAID BEFORE JANUARY 1, 1998, THIS EXCEPTION DOES NOT APPLY TO TUITION PAID IN 1997 TO COVER ACADEMIC PERIODS BEGINNING IN 1998.

Q20: If a student (who is not claimed as a dependent on anyone's Federal income tax return) pays qualified tuition and related expenses using a combination of a Pell Grant, a loan, a gift

from a family member, and some personal savings, what expenses may be taken into account in calculating the Hope Scholarship Credit the student may claim?

A20: The student may take into account only "out-of-pocket" expenses in calculating the credit. Qualified tuition and related expenses paid with the student's earnings, a loan, a gift, an inheritance, or personal savings (including savings from a qualified state tuition program) are taken into account in calculating the credit amount. However, qualified tuition and related expenses paid with a Pell Grant or other tax-free scholarship, a tax-free distribution from an Education IRA, or tax-free employer-provided educational assistance are not taken into account in calculating the credit amount. (The same rules apply for the Lifetime Learning Credit, described in the next section.)

Q21: May a student's parents claim the Hope Scholarship Credit for the student's expenses for a taxable year in which the student takes money out of an Education IRA on a tax-free basis?


A21: No. If a student is receiving a tax-free distribution from an Education IRA in a particular taxable year, none of that student's expenses may be claimed as the basis for a Hope Scholarship Credit for that taxable year. However, the student may waive the tax-free treatment of the Education IRA distribution and elect to pay any tax that would otherwise be owed on the Education IRA distributions received in any taxable year so that the student or the student's parents may claim a Hope Scholarship Credit for expenses paid in the same year the Education IRA distributions are received.

## 2. Lifetime Learning Credit

Beginning on July 1, 1998, taxpayers may be eligible to claim a nonrefundable Lifetime Learning Credit against their federal income taxes. The Lifetime Learning Credit may be claimed for the qualified tuition and related expenses of the students in the taxpayer's family (i.e., the taxpayer, the taxpayer's spouse, or an eligible dependent) who are enrolled in eligible educational institutions. Through 2002, the amount that may be claimed as a credit is equal to 20 percent of the taxpayer's first \$5,000 of out-of-pocket qualified tuition and related expenses for all the students in the family. After 2002, the credit amount is equal to 20 percent of the taxpayer's first \$10,000 of out-of-pocket qualified tuition and related expenses. Thus, the maximum credit a taxpayer may claim for a taxable year is \$1,000 through 2002 and \$2,000 thereafter. These amounts are not indexed for inflation.


If the taxpayer is claiming a Hope Scholarship Credit for a particular student, none of that student's expenses for that year may be applied toward the Lifetime Learning Credit. The amount a taxpayer may claim as a Lifetime Learning Credit is gradually reduced for taxpayers who have modified adjusted gross income between \$40,000 (\$80,000 for married taxpayers



filing jointly) and \$50,000 (\$100,000 for married taxpayers filing jointly). Taxpayers with modified adjusted gross income over \$50,000 (\$100,000 for married taxpayers filing jointly) may not claim a Lifetime Learning Credit. The modified adjusted gross income limitation will be indexed for inflation in 2002 and years thereafter. The definition of modified adjusted gross income is the same as it is for purposes of the Hope Scholarship Credit. (See  Sec. 1, Q&A6.)

The Lifetime Learning Credit may be claimed for payments of qualified tuition and related expenses made on or after July 1, 1998, for academic periods beginning on or after July 1, 1998. Therefore, the first time taxpayers will be able to claim the credit will be when they file their 1998 tax returns in 1999. The Lifetime Learning Credit is not available for any amount paid in 1997.


Q1: Who may claim the Lifetime Learning Credit?

A1: An individual paying qualified tuition and related expenses at a postsecondary educational institution may claim the credit, provided the institution is an eligible educational institution. Unlike the Hope Scholarship Credit, students are not required to be enrolled at least half-time in one of the first two years of postsecondary education. Nonresident aliens generally are not eligible to claim the Lifetime Learning Credit. (See  Sec. 1, Q&A7.)

Q2: May an individual claim a Lifetime Learning Credit for paying qualified tuition and related expenses for other family members?

A2: Yes. An individual may claim the credit for his/her own qualified tuition and related expenses and the qualified tuition and related expenses of his/her spouse and other eligible dependents (including children) for whom the dependency exemption is allowed. Generally, a parent may claim the dependency exemption for his/her unmarried child if: (1) the parent supplies more than half the child's support for the taxable year, and (2) the child is under age 19 or is a full-time student under age 24.

Q3: What are the eligibility requirements for the institution?

A3: They are the same requirements that apply for the Hope Scholarship Credit. (See  Sec. 1, Q&A4.)

Q4: Is the Lifetime Learning Credit available for a student taking only one course?

A4: Yes. For example, a student who has just graduated from high school and is taking a single course at a community college may claim the Lifetime Learning Credit if the student comes within the income limits and is not claimed as a dependent by someone else.

Q5: Are qualified tuition and related expenses for graduate-level education eligible for the

Lifetime Learning Credit?

A5: Yes.


Q6: May an individual claim a Lifetime Learning Credit for more than one family member?

A6: Yes. However, unlike the Hope Scholarship Credit, the Lifetime Learning Credit is calculated on a per family, rather than a per student, basis. Therefore, the maximum available credit does not vary with the number of students in the family. For example, if in 1999 a married individual whose modified adjusted gross income is \$35,000 pays \$5,000 of qualified tuition and related expenses to attend an eligible educational institution, the individual may claim a \$1,000 Lifetime Learning Credit. If in the same year the individual also pays another \$2,000 in qualified tuition and related expenses for his spouse to attend an eligible educational institution, the individual's Lifetime Learning Credit is still \$1,000.

Q7: May both the parent and a dependent child claim the Lifetime Learning Credit for the child's qualified tuition and related expenses in the same year?

A7: No. Either the parent or the child, but not both, may claim the credit for the child's expenses in a particular year. If an individual claims the child as a dependent on his/her Federal income tax return for the year, only the individual may claim the Lifetime Learning Credit for the child's qualified tuition and related expenses. If no one claims the child as a dependent on a Federal income tax return for the year, only the child may claim the Lifetime Learning Credit for the child's expenses.

Q8: How does a parent claim a Lifetime Learning Credit for the qualified tuition and related expenses of a dependent child?


A8: The parent may claim the credit on his/her Federal income tax return even if the child files his/her own tax return. When a child is claimed as a dependent on the parent's return, any qualified tuition and related expenses paid by the child during the year are treated as if the parent had paid them and, therefore, are included in calculating the parent's Lifetime Learning Credit. A child may not claim a Lifetime Learning Credit on his/her tax return for any year if the child's parent claims the child as a dependent in that same year. Also, a married taxpayer who does not file a joint return is not eligible to claim the Lifetime Learning Credit. (See  Sec. 1, Q&A11.)

Q9: What is the maximum Lifetime Learning Credit a taxpayer may claim?

A9: The credit is equal to 20 percent of the taxpayer's out-of-pocket expenses for qualified tuition and related expenses of all eligible family members, up to a maximum of \$5,000 in

expenses annually through 2002. Thus, the maximum Lifetime Learning Credit a taxpayer may claim through 2002 is \$1,000. After 2002, the credit is equal to 20 percent of the taxpayer's out-of-pocket expenses up to a maximum of \$10,000 in expenses. Thus, the maximum Lifetime Learning credit a taxpayer may claim after 2002 is \$2,000. The maximum credit does not change even if the taxpayer is claiming a credit for the expenses of more than one student in the family.

Q10: What does the term "qualified tuition and related expenses" mean for purposes of the Lifetime Learning Credit?

A10: The term "qualified tuition and related expenses" for purposes of the Lifetime Learning Credit has the same meaning as it does for purposes of the Hope Scholarship Credit. (See  Sec. 1, Q&A5.)

Q11: If a student (who is not claimed as a dependent on anyone's Federal income tax return) pays qualified tuition and related expenses using a combination of a Pell Grant, a loan, a gift from a family member, and some personal savings, what expenses may be taken into account in calculating the Lifetime Learning Credit the student may claim?

A11: The student may take into account only "out-of-pocket" expenses in calculating the Lifetime Learning Credit. Qualified tuition and related expenses paid with the student's earnings, a loan, a gift, an inheritance, or personal savings (including savings from a qualified state tuition program) are taken into account in calculating the credit amount. However, qualified tuition and related expenses paid with a Pell Grant or other tax-free scholarship, a tax-free distribution from an Education IRA, or tax-free employer-provided educational assistance are not taken into account in calculating the credit amount.

Q12: How does a taxpayer claim the Lifetime Learning Credit?

A12: The first year that the credit will be available is 1998. Taxpayers will not be able to claim the credit until they file their 1998 returns in 1999. Instructions accompanying the 1998 tax forms (for returns required to be filed in 1999) will explain how to calculate the credit and how to claim it on the tax return.

Q13: Is there a limit on the number of years in which a Lifetime Learning Credit may be claimed, as there is for the Hope Scholarship Credit?

A13: Unlike the Hope Scholarship Credit, there is no limit to the number of years in which a Lifetime Learning Credit may be claimed for each student. Thus, for example, an individual who enrolls in one college-level class every year would be able to claim the Lifetime Learning Credit for an unlimited number of years, provided the individual meets the income limits and is taking

the classes at institutions that meet the eligibility requirements. (See Q&A3 in this section.)

Q14: May a parent or student claim a Lifetime Learning Credit for tuition paid in advance of when the academic period begins?

A14: Generally, the credit is available only for payments of qualified tuition and related expenses that cover an academic period beginning in the same calendar year as the year in which payment is made. (An academic period begins on the first day of classes, and does not include periods of orientation, counseling, or vacation.) An exception, however, allows a parent or student to claim a Lifetime Learning Credit for payments of qualified tuition and related expenses made during the calendar year to cover an academic period that begins in January, February, or March of the following taxable year. BECAUSE THE LIFETIME LEARNING CREDIT DOES NOT APPLY TO EXPENSES PAID BEFORE JULY 1, 1998, THIS EXCEPTION DOES NOT APPLY TO TUITION PAID BEFORE THAT DATE TO COVER ACADEMIC PERIODS BEGINNING BEFORE OR AFTER THAT DATE.

Q15: May a student or a student's parents take the Lifetime Learning Credit for the student's expenses in a taxable year in which the student takes money out of an Education IRA on a tax-free basis?

A15: No. If a student is receiving a tax-free distribution from an Education IRA in a particular taxable year, none of that student's expenses may be claimed as the basis for a Lifetime Learning Credit for that year. However, the student may waive the tax-free treatment of the Education IRA distribution and elect to pay any tax that would otherwise be owed on the Education IRA distributions so that the student or the student's parents may claim a Lifetime Learning Credit for expenses paid in the same year the Education IRA distributions are received.

### 3. Education IRAs

Beginning January 1, 1998, taxpayers may deposit up to \$500 per year into an Education IRA for a child under age 18. Parents, grandparents, other family members, friends, and a child him/herself may contribute to the child's Education IRA, provided that the total contributions for the child during the taxable year do not exceed the \$500 limit. Amounts deposited in the account grow tax-free until distributed, and the child will not owe tax on any withdrawal from the account if the child's qualified higher education expenses at an eligible educational institution for the year equal or exceed the amount of the withdrawal. If the child does not need the money for postsecondary education, the account balance can be rolled over to the Education IRA of certain family members who can use it for their higher education. Amounts withdrawn from an Education IRA that exceed the child's qualified higher education expenses in a taxable year are

generally subject to income tax and to an additional tax of 10 percent. The Hope Scholarship Credit and Lifetime Learning Credit may not be claimed for a student's expenses in a taxable year in which the student takes a tax-free withdrawal from an Education IRA.


Q1: What is an Education IRA?

A1: An Education IRA is a trust or custodial account that is created or organized in the United States exclusively for the purpose of paying the qualified higher education expenses of the designated beneficiary of the account. The account must be designated as an Education IRA when it is created in order to be treated as an Education IRA for tax purposes

Q2: For whom may an Education IRA be established?

A2: An Education IRA may be established for the benefit of any child under age 18. Contributions to the Education IRA will not be accepted after the designated beneficiary reaches his/her 18<sup>th</sup> birthday.

Q3: Where may an individual open an Education IRA?

A3: An individual may open an Education IRA with any bank, or other entity that has been approved to serve as a nonbank trustee or custodian of an individual retirement account (IRA), and the bank or entity is offering Education IRAs. Other entities that wish to offer Education IRAs but are not approved to serve as IRA trustees or custodians may seek approval by following the same IRS procedures used for approval of other IRA nonbank trustees. See  **Notice** 97-57, 1997-43 I.R.B. (October 27, 1997).

Q4: When may a taxpayer start contributing to an Education IRA for a child?

A4: A taxpayer may start making contributions on January 1, 1998, or at any time thereafter.

Q5: How much may be contributed to a child's Education IRA?

A5: Up to \$500 per year in aggregate contributions may be made for the benefit of any child. The contributions may be placed in a single Education IRA or in multiple Education IRAs.

Q6: What happens if more than \$500 is contributed to an Education IRA on behalf of a child in a calendar year?

A6: Aggregate contributions for the benefit of a particular child in excess of \$500 for a calendar year are treated as excess contributions. If the excess contributions (and any earnings attributable to them) are not withdrawn from the child's account (or accounts) before the tax return for the year is due, the excess contributions are subject to a 6 percent excise tax for

each year the excess amount remains in the account.


Q7: May contributions other than cash be made to a child's Education IRA?

A7: No. Education IRAs are permitted to accept contributions made in cash only.

Q8: May contributors take a deduction for contributions made to an Education IRA?

A8: No.

Q9: Are there any restrictions on who can contribute to an Education IRA?

A9: Any individual may contribute up to \$500 to a child's Education IRA if the individual's modified adjusted gross income for the taxable year is no more than \$95,000 (\$150,000 for married taxpayers filing jointly). (See  Sec. 1, Q&A6 for a description of modified adjusted gross income.) The \$500 maximum contribution per child is gradually reduced for individuals with modified adjusted gross income between \$95,000 and \$110,000 (between \$150,000 and \$160,000 for married taxpayers filing jointly). For example, an unmarried taxpayer with modified adjusted gross income of \$96,500 in a taxable year could make a maximum contribution per child of \$450 for that year. Taxpayers with modified adjusted gross income above \$110,000 (\$160,000 for married taxpayers filing jointly) cannot make contributions to anyone's Education IRA.

Q10: May a child contribute to his/her own Education IRA?

A10: Yes.

Q11: Does a taxpayer have to be related to the designated beneficiary in order to contribute to the designated beneficiary's Education IRA?

A11: No.

Q12: How many Education IRAs may a child have?

A12: There is no limit on the number of Education IRAs that may be established designating a particular child as beneficiary. However, in any given taxable year the total aggregate contributions to all the accounts designating a particular child as beneficiary may not exceed \$500.


Q13: May a designated beneficiary take a tax-free withdrawal from an Education IRA to pay qualified higher education expenses if the designated beneficiary is enrolled less than full-time at an eligible educational institution?

A13: Yes. Whether the designated beneficiary is enrolled full-time, half-time, or less than half-time, he/she may take a tax-free withdrawal to pay qualified higher education expenses.




Q14: What happens when a designated beneficiary withdraws assets from an Education IRA to pay for college?

A14: Generally, the withdrawal is tax-free to the designated beneficiary to the extent the amount of the withdrawal does not exceed the designated beneficiary's qualified higher education expenses.

Q15: What are "qualified higher education expenses"?

A15: "Qualified higher education expenses" mean expenses for tuition, fees, books, supplies, and equipment required for the enrollment or attendance of the designated beneficiary at an eligible educational institution. Qualified higher education expenses also include amounts contributed to a qualified state tuition program. Qualified higher education expenses also include room and board (generally the school's posted room and board charge, or \$2,500 per year for students living off-campus and not at home) if the designated beneficiary is at least a half-time student at an eligible educational institution. The standards for determining whether a student is enrolled at least half-time are the same as those used for the Hope Scholarship Credit. (See  Sec. 1, Q&A3.)

Q16: What is an eligible educational institution?

A16: An eligible educational institution is any college, university, vocational school, or other postsecondary educational institution that is described in section 481 of the Higher Education Act of 1965 (20 U.S.C. 1088) and, therefore, eligible to participate in the student aid programs administered by the Department of Education. This category includes virtually all accredited public, nonprofit, and proprietary postsecondary institutions. (The same eligibility requirements for institutions apply for the Hope Scholarship Credit, the Lifetime Learning Credit, and early withdrawals from IRAs for qualified higher education expenses.) (See  Sec. 1, Q&A4,  Sec. 2, Q&A3, and  Sec. 4, Q&A2.)

Q17: What happens if a designated beneficiary withdraws an amount from an Education IRA but does not have any qualified higher education expenses to pay in the taxable year he/she makes the withdrawal?

A17: Generally, if a designated beneficiary withdraws an amount from an Education IRA and does not have any qualified higher education expenses during the taxable year, a portion of the distribution is taxable. The taxable portion is the portion that represents earnings that have accumulated tax-free in the account. The taxable portion of the distribution is also subject to a

10 percent additional tax unless an exception applies.

Q18: Is a distribution from an Education IRA taxable if the distribution is contributed to another Education IRA?

A18: Any amount distributed from an Education IRA and rolled over to another Education IRA for the benefit of the same designated beneficiary or certain members of the designated beneficiary's family is not taxable. An amount is rolled over if it is paid to another Education IRA on a date within 60 days after the date of the distribution. Members of the designated beneficiary's family include the designated beneficiary's children and their descendants, stepchildren and their descendants, siblings and their children, parents and grandparents, stepparents, and spouses of all the foregoing. The \$500 annual contribution limit to Education IRAs does not apply to these rollover contributions. For example, an older brother who has \$2,000 left in his Education IRA after he graduates from college can roll over the full \$2,000 balance to an Education IRA for his younger sister who is still in high school without paying any tax on the transfer.

Q19: What happens to the assets remaining in an Education IRA after the designated beneficiary finishes his/her postsecondary education?

A19: There are two options. The amount remaining in the account may be withdrawn for the designated beneficiary. The designated beneficiary will be subject to both income tax and the additional 10 percent tax on the portion of the amount withdrawn that represents earnings if the designated beneficiary does not have any qualified higher education expenses in the same taxable year he/she makes the withdrawal. Alternatively, if the amount in the designated beneficiary's Education IRA is withdrawn and rolled over (as described in Q&A18 of this section) to another Education IRA for the benefit of a member of the designated beneficiary's family, the amount rolled over will not be taxable.

Q20: Rather than rolling over money from one Education IRA to another, may the designated beneficiary of the account be changed from one child to another without triggering a tax?

A20: Yes, provided: (1) the terms of the particular trust or custodial account permit a change in designated beneficiaries (each trustee or custodian will control whether options like this one are available in the accounts they offer), and (2) the new designated beneficiary is a member of the previous designated beneficiary's family. (See Q&A18 in this section).

Q21: May a student or the student's parents claim the Hope Scholarship Credit or Lifetime Learning Credit for the student's expenses in a taxable year in which the student receives money from an Education IRA on a tax-free basis?



A21: No. If a student is receiving a tax-free distribution from an Education IRA in a particular taxable year, none of that student's expenses may be claimed as the basis for a Hope Scholarship Credit or Lifetime Learning Credit for that year. However, the student may waive the tax-free treatment of the Education IRA distribution and elect to pay any tax that would otherwise be owed on an Education IRA distribution so that the student or the student's parents may claim a Hope Scholarship Credit or Lifetime Learning Credit for expenses paid in the same year the Education IRA distributions are received.


Q22: May contributions be made to both a qualified state tuition program and an Education IRA on behalf of the same designated beneficiary in the same taxable year?

A22: No. Any amount contributed to an Education IRA on behalf of a designated beneficiary during any taxable year in which an amount is also contributed to a qualified state tuition program on behalf of the same beneficiary will be treated as an excess contribution to the Education IRA. (See Q&A6 in this section for the treatment of excess contributions.)

## 4. Using IRA Withdrawals To Pay Higher Education Expenses




Beginning January 1, 1998, a taxpayer may make withdrawals from an individual retirement account (IRA) to pay the qualified higher education expenses for the taxpayer, the taxpayer's spouse, or the child or grandchild of the taxpayer or taxpayer's spouse at an eligible educational institution. The taxpayer will owe federal income tax on the amount withdrawn, but will not be subject to the 10 percent early withdrawal tax that applies when amounts are withdrawn from an individual retirement account before the account holder reaches age 59-½.

Q1: When can an individual first make a withdrawal from an IRA to pay for qualified higher education expenses without paying the 10 percent early withdrawal tax?

A1: On or after January 1, 1998, an individual can make withdrawals from his/her IRA to pay for qualified higher education expenses for academic periods beginning on or after January 1, 1998, without paying the 10 percent early withdrawal tax. See  **Notice** 97-53, 1997-40 IRB. The 10 percent early withdrawal tax does not apply to a distribution from an IRA to the extent that the amount of the distribution does not exceed the qualified higher education expenses for the taxpayer, the taxpayer's spouse, and the child or grandchild of the taxpayer or the taxpayer's spouse at an eligible educational institution. For purposes of this rule, the term "qualified higher education expenses" means tuition, fees, books, supplies and equipment required for the enrollment or attendance of the student at an eligible educational institution. Qualified higher education expenses also include room and board if the student is enrolled at least half-time. Qualified higher education expenses paid with an individual's earnings, a loan, a

gift, an inheritance given to the student or the individual claiming the credit, or personal savings (including savings from a qualified state tuition program) are included in determining the amount of the IRA withdrawal which is not subject to the 10 percent early withdrawal tax. Qualified higher education expenses paid with a Pell Grant or other tax-free scholarship, a tax-free distribution from an Education IRA, or tax-free employer-provided educational assistance are excluded.

Q2: What are the requirements for an “eligible educational institution”.

A2: An “eligible educational institution” is any college, university, vocational school, or other postsecondary educational institution that is described in section 481 of the Higher Education Act of 1965 (20 U.S.C. 1088) and, therefore, eligible to participate in the student aid programs administered by the Department of Education. This category includes virtually all accredited public, nonprofit, and proprietary postsecondary institutions. (The same eligibility requirements for institutions apply for the Hope Scholarship Credit, the Lifetime Learning Credit, and Education IRAs.) (See  Sec. 1, Q&A4,  Sec. 2, Q&A3, and  Sec. 3, Q&A16.)

Q3: When are IRA withdrawals usually subject to the 10 percent early withdrawal tax?

A3: Generally, if a taxpayer makes a withdrawal from his/her IRA before reaching age 59-½, the taxpayer must pay the 10 percent early withdrawal tax on all or part of the amount withdrawn.

Q4: In addition to the Education IRA, TRA '97 also created the Roth IRA. May a taxpayer make a withdrawal from a Roth IRA to pay for his/her child's qualified higher education expenses?

A4: Yes. A taxpayer may make a withdrawal from a Roth IRA, as they can from other IRAs, to pay qualified higher education expenses without paying the 10 percent early withdrawal tax.

## 5. Student Loan Interest Deduction

Beginning January 1, 1998, taxpayers who have taken loans to pay the cost of attending an eligible educational institution for themselves, their spouse, or their dependent generally may deduct interest they pay on these student loans. The maximum deduction each taxpayer is permitted to take increases from \$1,000 in 1998 to \$2,500 in 2001 and thereafter. The following table summarizes the yearly increases.

Year	Maximum Deduction
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1998	\$1,000
1999	\$1,500
2000	\$2,000

2001 and thereafter

\$2,500

The deduction is available only for interest payments made during the first 60 months in which interest payments are required on the loan. The student loan interest deduction is available for interest payments due and made on or after January 1, 1998. Thus, the first time taxpayers will be able to claim the deduction is when they file their 1998 tax returns in 1999. No student loan interest deduction will be allowed for interest due or paid before 1998.



Q1: Are there any limits on what qualifies as a student loan?

A1: Yes. The loan must have been used to pay the costs of attendance at an eligible educational institution for a student enrolled at least half-time in a program leading to a degree, certificate, or other recognized educational credential. An eligible educational institution is any college, university, vocational school, or other postsecondary educational institution that is described in section 481 of the Higher Education Act of 1965 (20 U.S.C. 1088) and, therefore, eligible to participate in the student aid programs administered by the Department of Education. This category includes virtually all accredited public, nonprofit, and proprietary postsecondary institutions. For purposes of the student loan interest deduction, eligible educational institutions also include institutions that conduct an internship or residency program leading to a degree or certificate awarded by an institution of higher education, a hospital, or a health care facility that offers postgraduate training.

Q2: Is a student loan interest deduction available if the student loan is not federally guaranteed or otherwise subsidized?

A2: Yes. As long as the loan was used to pay the costs of attendance at an eligible educational institution and the other eligibility requirements are met, the deduction is available for the interest on the loan. The deduction does not depend on whether the loan is federally guaranteed or subsidized.

Q3: What costs are included in the costs of attendance?

A3: Costs of attendance include all items that are included in costs of attendance for purposes of calculating a student's financial need in accordance with the Higher Education Act. Thus, they include tuition, fees, room, board, books, equipment, and other necessary expenses, such as transportation. Costs of attendance include more items than are included in qualified tuition and related expenses for purposes the Hope Scholarship and Lifetime Learning Credits. (See  Sec. 1, Q&A5 and  Sec. 2, Q&A10.)

Q4: Is the deduction available for interest paid on loans used to pay for graduate school?

A4: Yes.

Q5: Are there any limits on who may take the student loan interest deduction?

A5: Yes, there are income restrictions. To claim the maximum deduction, a taxpayer must have modified adjusted gross income of \$40,000 or less (\$60,000 for married taxpayers filing jointly). The amount of the taxpayer's deduction is gradually reduced for taxpayers with modified adjusted gross income between \$40,000 and \$55,000 (between \$60,000 and \$75,000 for married taxpayers filing jointly). For example, for 1998, the maximum deduction a single taxpayer with modified adjusted gross income of \$47,500 could take would be \$500. Taxpayers with modified adjusted gross income above \$55,000 (\$75,000 for married taxpayers filing jointly) may not claim the student loan interest deduction. The modified adjusted gross income limitations are indexed for inflation after 2002.

Q6: May a former student whose loans are already in repayment deduct the interest they pay on a student loan on or after January 1, 1998?

A6: Yes, but they may deduct only those payments made during the first 60 months that interest payments are required on a loan. If interest payments on a student loan were first required before January 1, 1998, the months in which those payments were required count against the 60-month time limit for that loan. The 60-month period may run out at different times for different loans.

Q7: May a parent claim the student loan interest deduction if the parent borrows to pay his/her child's costs of attending college?

A7: Yes. An individual may claim the student loan interest deduction if the individual borrows money to pay the costs of attending college for certain members of the individual's family or household (including his/her children) and incurs the debt in a year in which the individual supplies more than half of the student's support.

Q8: If an individual has paid more than \$1,000 in interest on student loans in 1998 and is otherwise eligible to take the maximum student loan interest deduction, how large a deduction may the individual claim?

A8: The individual's student loan interest deduction for 1998 is \$1,000, provided the individual's modified adjusted gross income falls below the point where the deduction is reduced or eliminated.

Q9: Does an individual have to itemize his/her income tax deductions to claim the student loan interest deduction?

A9: No. The student loan interest deduction is available regardless of whether an individual elects to take the standard deduction or to itemize deductions. Instructions accompanying the 1998 tax forms (for returns required to be filed in 1999) will explain how to compute and claim the deduction.

Q10: If a student is claimed as a dependent by his/her parent in a particular taxable year, may the student take the student loan interest deduction for student loan interest that he/she pays in that year?

A10: No. The student may not claim the student loan interest deduction in any taxable year in which he/she is claimed as a dependent on another taxpayer's return. However, if the student continues to pay interest on a student loan and meets the other eligibility requirements, the student may claim the student loan interest deduction for payments made in a later year when the student is no longer a dependent on his/her parent's Federal income tax return.

Q11: Are there any tax benefits available if the student repays his/her loan by performing community service rather than making cash payments?


A11: There may be. Loan forgiveness provided in return for community service is tax-free when it is part of certain lending programs run by the Federal, state, or local government, educational institutions, or charitable organizations. Students should consult a tax advisor to determine whether they qualify.

## 6. Qualified State Tuition Programs

Under current law, a qualified state tuition program (QSTP) means a program established and maintained by a state under which a person may: (1) prepay tuition benefits on behalf of a beneficiary so that the beneficiary is entitled to a waiver or a payment of qualified higher education expenses, or (2) contribute to an account that is established for paying qualified higher education expenses of the beneficiary. The tax on earnings attributable to prepayments or contributions is deferred until the earnings are distributed from the QSTP. The beneficiary pays tax on the earnings at the time of distribution. If amounts saved through a QSTP are used to pay for college, the student or the student's parents still may be eligible to claim either the Hope Scholarship Credit or the Lifetime Learning Credit.

Q1: How have the prior rules for QSTPs been changed by TRA '97?

A1: (1) QSTPs may now be used to save for room and board expenses, up to a specified level (generally the school's posted room and board charge, or \$2,500 per year for students living off-campus and not at home); (2) QSTPs may now be used to pay expenses not only at public

and nonprofit institutions but also at proprietary schools (i.e., any school that is an eligible educational institution for purposes of the Hope Scholarship or Lifetime Learning Credits, see  Sec. 1, Q&A4); (3) Accounts in QSTPs may now be transferred tax-free from the beneficiary to a broader range of family members. (Step-siblings and spouses of family members have been added.)


Q2: May a student using a QSTP to pay for college also benefit from the Hope Scholarship Credit or Lifetime Learning Credit?

A2: Yes. The student or the student's parent may claim a Hope Scholarship Credit or Lifetime Learning Credit for qualified tuition and related expenses covered by a qualified state tuition program, provided the other eligibility requirements for the credits are met.

Q3: When are the changes to the QSTP rules made by TRA '97 effective?

A3: Generally, the new rules go into effect on January 1, 1998. However, the new provision permitting QSTPs to be used to save for room and board expenses is effective back to August 20, 1996.

Q4: May contributions be made to both a qualified state tuition program and an Education IRA on behalf of the same designated beneficiary in the same taxable year?

A4: No. Any amount contributed to an Education IRA on behalf of a designated beneficiary during any taxable year in which an amount is also contributed to a qualified state tuition program on behalf of the same beneficiary will be treated as an excess contribution to the Education IRA. (See  Sec. 3, Q&A6 for the treatment of excess contributions to an Education IRA.)

## 7. Exclusion For Employer-Provided Educational Assistance

TRA '97 extends tax-free treatment to employer-provided educational assistance for undergraduate courses that begin before June 1, 2000. Employers may continue to provide up to \$5,250 per year in educational assistance to each employee on a tax-free basis for courses beginning before that date, regardless of whether the education is job-related. This benefit expires for assistance in paying for courses that begin on or after June 1, 2000.

Q1: How does an employee learn whether tax-free educational assistance is available to him/her?

A1: Employers have this information. Employers offering tax-free educational assistance are

required to have a written plan describing the benefit and the terms under which it is available.

Q2: Does the employee have to do anything special to avoid being taxed on employer-provided educational assistance, up to the \$5,250 limit?

A2: No. The employer will automatically treat the educational assistance as a tax-free benefit and will not include it as wages on the employee's W-2 form.

Q3: May an employee receive tax-free educational assistance from the employer to attend graduate school?

A3: In general, no. However, employers can provide job-related educational assistance for graduate-level education as a tax-free fringe benefit under certain circumstances. Educational assistance would generally qualify as job-related if it maintains or improves skills required for the employee's current job or satisfies certain express employer-imposed conditions for continued employment. Individuals should consult a tax advisor for help in determining the tax treatment of any assistance the individual may be receiving from an employer for graduate-level education.

Q4: If a student is enrolled in undergraduate courses in a particular year and owes \$3,000 in qualified tuition and related expenses, and the student's employer pays all of the student's qualified tuition and related expenses, may a Hope Scholarship Credit or a Lifetime Learning Credit be claimed for that student for that year?

A4: No. Neither the Hope Scholarship Credit nor the Lifetime Learning Credit may be claimed for that student for that year.

## Further Information

For further information contact: Donna J. Welch, (202) 622-4910 regarding the Hope Scholarship and Lifetime Learning Credits; Monice L. Rosenbaum, (202) 622-6070 regarding employer-provided educational assistance and qualified state tuition programs; Pamela R. Kinard, (202) 622-6030 regarding Education IRAs and using IRA withdrawals to pay for higher education expenses; and John Moriarty, (202) 622-4950 regarding student loan interest deduction (not toll-free numbers).

The IRS will publish additional guidance on the provisions discussed in this **notice** as well as other provisions included in TRA '97. You may visit the IRS worldwide web site at ([http://www.irs.ustreas.gov/hot/tax\\_law.html](http://www.irs.ustreas.gov/hot/tax_law.html)) for information on additional guidance as it becomes available.

The Department of Education has a worldwide web site ([http://www.ed.gov/prog\\_info/SFA/StudentGuide](http://www.ed.gov/prog_info/SFA/StudentGuide)) you can visit and telephone numbers (1-800-4FED-AID and 1-800-USA-LEARN) you can call to get more information on affording college and obtaining student aid, such as Pell grants and student loans.

## **Drafting Information**

The principal authors of this notice are Donna J. Welch, Office of Assistant Chief Counsel (Income Tax and Accounting) and Monice L. Rosenbaum and Pamela R. Kinard, Office of Associate Chief Counsel (Employee Benefits and Exempt Organizations). However, other personnel from the IRS and Treasury Department participated in its development.

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