Most-Overlooked Deductions and Tax Breaks

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1. Hope Credit

The tax law allows you to claim a limited tax credit, called the Hope credit, when you pay for higher education. The credit applies whether you pay out-of-pocket from savings or borrow the money. You may claim the credit each year you qualify for it.

Benefit

There are two tax credits related to higher education expenses: the Hope credit and the lifetime learning credit. If you meet certain conditions, you can claim the Hope credit for higher education costs of up to $1,500 per student (100 percent of the first $1,000 of costs, plus 50 percent of the next $1,000 of costs). Thus, for example, if you have twins who are freshmen in college, you can qualify for a credit of up to $3,000.

Conditions

To claim the Hope credit, you must meet all five of these conditions:

1. Payments relate to the first two years of higher education.

2. Payments are made on behalf of an eligible student.

3. Payments are made to an eligible institution.

4. Payments cover qualified higher education costs.

5. Your modified adjusted gross income is not above a set limit.

FIRST TWO YEARS OF HIGHER EDUCATION. The credit applies for only the first two years of college or other postsecondary school. In effect, you can claim the credit only twice for the same student—for year one and for year two. This is so even if the student has not completed two full years (as measured by credits required for such completion).

EXAMPLE:

Your child starts college in September 2002, attending both the fall and spring semesters. Your child again enrolls in September 2003 for the fall and spring semesters. You may claim a credit for 2002 based on tuition for the fall semester (essentially half the year) and a credit in 2003 for the spring semester of your child's freshman year and the fall semester of his sophomore year (a full year). You cannot claim the Hope credit for tuition paid for the spring semester in 2004.

ELIGIBLE STUDENT. The credit may be claimed for you, your spouse, or your dependent for whom you claim an exemption on your return. The student must be enrolled for at least one academic period (a semester, trimester, or quarter) during the year.
No credit may be claimed if the student has a felony drug conviction on his or her record.

ELIGIBLE EDUCATIONAL INSTITUTION. Only payments to an eligible institution entitle you to claim the credit. This includes any accredited public, nonprofit, or proprietary postsecondary institution eligible to participate in the student aid programs administered by the U.S. Department of Education. Ask your school if it is eligible, or check www.studentaid.ed.gov.
Enrollment must lead to a degree, certificate, or other recognized educational credential.

QUALIFIED HIGHER EDUCATION COSTS. Qualified expenses include *only* tuition and related fees. Related fees can include, for example, a student activity fee paid to the institution if it is required for all students and no portion of it covers personal expenses. Hobby or sports courses and noncredit courses do not qualify for the credit *unless* they are part of the student's degree program.

The following costs do *not* qualify for the credit:

• Room and board (even if they are required to be paid to the institution as a condition of enrollment).
• Books and supplies (unless they are required to be purchased directly from the institution).
• Medical expenses.
• Transportation.
• Insurance.
• Personal living expenses.

As a practical matter, the institution furnishes the student with an information return showing the payment of qualified tuition and related expenses for the year. The return, Form 1098-T, Tuition Payments Statement, for 2003 is issued by January 31, 2004.

If you prepay expenses for an academic period that begins within the first three months of 2004, you can include this amount when figuring your 2003 credit.

MAGI LIMIT. The ability to claim the credit depends on your modified adjusted gross income (MAGI). MAGI for this purpose is adjusted gross income increased by the foreign earned income exclusion and other foreign items.

If your MAGI is below a phaseout range, then the full credit can be claimed; a partial credit is allowed for those with MAGI within the range. No credit can be claimed if MAGI exceeds the range. The phaseout range is adjusted annually for inflation. Table 3.1 shows the phaseout ranges for 2003.

Planning Tips

You can claim the credit even though eligible expenses are paid with the proceeds of a loan. You can also claim the credit if eligible expenses are paid by someone other than you, your spouse, or your dependent, such as the student's grandparent. The payment is treated as having been made by the student, and as your dependent, this entitles you to claim the credit if you are otherwise eligible to do so.

EXAMPLE:

December 2003 you pay tuition for your child for the semester beginning

February 2004. You can include the tuition payment as part of qualified expenses in figuring your 2003 credit.

In 2003, you are single, with MAGI of $46,000. Your top credit is limited to

$750 (one half of the maximum credit of $1,500), since you are midway in the MAGI phaseout range. If your MAGI is $40,000, you can claim a credit up to $1,500; if your MAGI is over $51,000, you cannot claim any credit

As the parent, if you pay the expenses but your MAGI is too high to permit you to claim the credit, you can waive your right to do so. This will allow your child to claim the credit on his or her own return (assuming the child has tax liability and can benefit from the credit). Your child can claim the credit even though you pay the expenses.

To allow your child to claim the credit you must forgo the dependency exemption for your child. To make the waiver, you do not have to file any special waiver forms or attach any statements to your return or to the child's return.

If your child cannot use the credit, consider taking the above-the-line deduction for tuition and fees if you are qualified to do so (explained later in this chapter). The tuition and fees deduction has a higher MAGI limit so you may qualify for this benefit even though your MAGI prevents you from claiming the credit.

Pitfalls

The credit must be coordinated with other education tax benefits you may be qualified to use. You can claim the credit in the same year in which you receive distributions from a Coverdell education savings account (ESA) or 529 plan. However, the expenses on which you base the credit cannot be the same expenses used to figure the tax-free portion of the distributions.

If you claim a credit and in a later year (after you have filed the return and claimed the credit) receive a refund of an amount that was used to figure the credit, you must recapture some or all of the credit. This means you must repay some or all of the credit. You treat the recaptured amount as additional tax liability for the year of recapture. Do not amend the return on which the credit was claimed.

2003 MAGI Phaseout Range for Hope Credit

Filing Status	MAGI
Married filing jointly	**$83,000–103,000**
Other filing status*	**$41,000–51,000**

***No credit may be claimed for married filing separately.**

EXAMPLE:

Your child's college tuition bill for the year is $15,000. You pay $5,000 of this amount from a 529 plan. For purposes of figuring the credit, you can only take $10,000 of eligible expenses into account ($5,000 is used as a tax-free distribution from the 529 plan).

You may not claim the Hope credit if you claim an above-the-line deduction for tuition and fees for a student (discussed later in this chapter). You must choose which write-off gives you the greater benefit, assuming you qualify for each.
You cannot claim the credit for expenses that are paid by tax-free scholarships, fellowships, grants, veterans' educational assistance, or employer-provided educational assistance.

Where to Claim the Credit

The Hope credit is figured on Form 8863, Education Credits. The credit is then entered in the "Tax and Credits" section of Form 1040, or in the "Tax, Credits, and Payments" section of Form 1040A.
You may not claim the credit if you file Form 1040EZ.

2. Tuition and Fees Deduction

The tax law allows you to claim a limited deduction when you pay for higher education. The deduction applies whether you pay out-of-pocket from savings or borrow the money. You may claim the deduction each year you qualify for it.

Benefit

If you pay tuition and fees for higher education for you, your spouse, or a dependent, you may be able to deduct up to $3,000 in 2003 as an adjustment to gross income, even if you don't itemize your other deductions.

Conditions

To claim the deduction for tuition and fees, you must meet all five of these conditions:
1. Be an eligible taxpayer.
2. Make payments to an eligible educational institution.
3. Pay qualified expenses.
4. Have MAGI below a set amount.
5. You do not claim an education credit.

ELIGIBLE TAXPAYER. You can claim the deduction for you, your spouse, or your dependent for whom you claim an exemption on your return.
You may not claim the deduction if you are married filing separately. You may not claim the deduction if you can be claimed as a dependent on another taxpayer's return.
ELIGIBLE EDUCATIONAL INSTITUTION. Only tuition and fees paid to an eligible educational institution qualify for the deduction. An eligible education institution includes any college, university, vocational school, or postsecondary institution eligible to participate in the financial aid programs of the U.S. Department of Education.
QUALIFIED EXPENSES. The same expenses that qualify for the Hope credit discussed earlier qualify for the tuition and fees deduction. Student activity fees and even the cost of books can be treated as deductible fees if the cost is paid to the eligible educational institution. As a practical matter, the institution furnishes the student with an information return showing the payment of qualified tuition and related expenses for the year. The return, Form 1098-T, Tuition Payments Statement, for 2003 is issued by January 31, 2004.
Qualified expenses do not include any amounts paid by tax-free scholarships, tax-free distributions from Coverdell education savings accounts or 529 plans, and excludable interest from the redemption of U.S. savings bonds.
Qualified expenses paid directly to the educational institution under a court-approved divorce decree are treated as paid by the student (not by the person making the payments), so only the student is eligible to claim the deduction.
Remember that the student can claim the deduction only if he or she cannot be claimed as the dependent of another taxpayer.
The same treatment applies to qualified expenses paid by someone else (such as a grandparent). Again, the student is treated as making the payment, and the student is eligible to claim the deduction only if he or she cannot be claimed as the dependent of another taxpayer.

MAGI LIMIT. You can claim the deduction only if your MAGI is no more than the limit found in Table 3.2. MAGI for this purpose is adjusted gross income increased by the foreign earned income exclusion, income from Puerto Rico or American Samoa, or the foreign housing exclusion or deduction.

2003 MAGI Limits for Tuition Deduction

Filing Status	MAGI
Married filing jointly	**$130,000**
Other taxpayers	**$ 65,000**

NO EDUCATION CREDIT. You cannot claim the deduction for a student's expenses for which you claim a Hope credit or lifetime learning credit (education credits). If you qualify for both the tuition and fees deduction and an education credit, you must choose the write-off that provides the greater benefit; generally this will be a credit.

Planning Tip

In 2004, the deduction limit increases to $4,000 and a smaller deduction of $2,000 is permitted. Table 3.3 shows the MAGI limits for claiming the $4,000 or $2,000 deduction. If your MAGI is more than $160,000 on a joint return, or more than $80,000 if you are unmarried, no deduction can be claimed.

Pitfall

Even one dollar over the MAGI limit prevents you from claiming a deduction. There is no phaseout of this deduction, as there is with many other deductions. ***Note:*** The deduction is set to expire after 2005.

Where to Claim the Deduction

The deduction is claimed on Form 1040 or 1040A in the section called "Adjusted Gross Income." No special form or schedule is required. You cannot claim the deduction if you file Form 1040EZ.

You are married and file a joint return with your spouse. If your MAGI is:

- **No more than $130,000, your deduction is $3,000.**
- **Over $130,000, your deduction is zero.**

2004–2005 MAGI Limits for Tuition Deduction

Filing Status*	MAGI Limit for $4,000 Deduction	MAGI Limit for $2,000 Deduction
Married filing joint	**Not more than $130,000**	**More than $130,000 but not more than $160,000**
Other taxpayers	**Not more than $65,000**	**More than $65,000 but not more than $80**

***You cannot claim the deduction if you are married filing separately.**

3. Coverdell Education Savings Accounts

Is the high cost of a prep school or college in your child or grandchild's future? If you decide to help save for this expense, consider doing so using a tax-advantaged savings account, called a Coverdell education savings account (ESA), designed for this purpose.

Benefit

You may be able to contribute up to $2,000 annually to a savings account for each beneficiary. The account is called a Coverdell education savings account (ESA) (it used to be called an education IRA). The account can have multiple contributors, but no more than $2,000 can be placed in the account for any one year.

Earnings on contributions accumulate tax deferred. If withdrawals from the account are used to pay qualified education expenses, the earnings become tax free.

Conditions

There are a couple of conditions for funding a Coverdell education savings account as well as for taking tax-free distributions.

1. For purposes of contributions, they can be made only on behalf of an eligible beneficiary (defined next) by a contributor whose modified adjusted gross income does not exceed set limits. Contributions must be made in cash, not property.

2. For purposes of tax-free distributions, funds must be used only for eligible expenses.

ELIGIBLE BENEFICIARY. Generally, a beneficiary is a person who is under the age of 18 at the time the contribution is made. Thus, for example, if a beneficiary attains the age of 18 on July 1, 2003, contributions can be made through June 30, 2003.

A beneficiary can also be a special needs person over the age of 18. A special needs beneficiary is one who requires additional time to complete his or her education because of a physical, mental, or emotional condition. This would include, for example, a person with a learning disability.

MAGI FOR CONTRIBUTORS. There is no familial requirement for contributors. Anyone can make a Coverdell education savings account contribution on behalf of an eligible beneficiary, as long as the contributor meets MAGI limits. Contributions can even be made by the beneficiary herself.

In order to contribute the full $2,000 to a Coverdell education savings account, your modified adjusted gross income cannot be more than a set limit.

MAGI for this purpose means adjusted gross income increased by the foreign earned income exclusion, the foreign housing exclusion or deduction, the exclusion for income from American Samoa, or the exclusion for income from Puerto Rico.

A reduced contribution limit applies if your MAGI falls within a phaseout range. No contribution can be made if your MAGI exceeds the phaseout range, which is adjusted annually for inflation. The MAGI phaseout range for Coverdell ESA contributors in 2003 may be found in Table 3.6.

CASH CONTRIBUTIONS. Contributions must be made in cash; you cannot contribute property to a Coverdell ESA. If you own stocks or mutual funds, you must sell the property and invest the proceeds. You may incur a capital gain on the sale of property.

ELIGIBLE EXPENSES. Unlike most other education tax breaks that are restricted to higher education, Coverdell education savings accounts can be used for education in grades K–12 and/or for higher education. Primary and secondary school can be public, private, or religious school.

The range of eligible expenses for which tax-free withdrawals can be made is quite broad. Just about anything related to education is a qualified expense.

EXAMPLES OF ELIGIBLE ELEMENTARY AND SECONDARY SCHOOL EXPENSES

Academic tutoring.

Books.

Computer and peripheral equipment; software only if it is predominantly educational in nature.

Extended day programs required or provided by the school.

Internet access.

Special services for a special needs beneficiary.

Supplies.

2003 MAGI Phaseout Ranges for Coverdell ESA Contributors

Filing Status	MAGI Phaseout Range
Married filing jointly	**$190,000–220,000**
Other taxpayers	**$ 95,000–110,000**

In 2003, you are a single parent with MAGI of $80,000. You can make a $2,000 contribution on behalf of your 12-year-old child. But if your MAGI is between $95,000 and $110,000, only part of the $2,000 may be contributed (you figure the limit using a worksheet provided in IRS Publication 970).

Transportation.

Uniforms.

EXAMPLES OF ELIGIBLE HIGHER EDUCATION EXPENSES

Books, supplies, and equipment.

Room and board.

Tuition and fees.

Planning Tips

You can open a Coverdell education savings account at any bank or other financial institution that has received IRS approval to offer Coverdell ESAs. You can then select the investments you prefer, from certificates of deposit to stocks and mutual funds (to the extent available from the institution you select).

Just like IRA contributions, contributions to Coverdell ESAs can be made up to the due date of the return for the year to which they relate. However, obtaining a filing extension does not extend the deadline for making contributions.

You can turn taxable custodial accounts into tax-free Coverdell education savings accounts by using the funds in the custodial account for contributions. However, only cash contributions are permitted to a Coverdell education savings account, so investments in the custodial accounts must first be sold so that the proceeds can be contributed.

Contributions for 2003 may be made up to April 15, 2004, even if the contributor and/or the beneficiary has obtained a four-month filing extension.

Junior has $5,000 in a custodial account that owns shares in a mutual fund, the earnings from which are reported annually as taxable income to Junior. He can

opt to sell $2,000 from the mutual fund in his custodial account each year and contribute the proceeds to a Coverdell education savings account of which he is the designated beneficiary (assuming he meets the age and MAGI limits). The account can own shares in the same mutual fund, but now the earnings become tax deferred and, if funds are withdrawn for qualified expenses, they become tax free.

You can change accounts from one financial institution to another by means of a tax-free rollover. You may not be satisfied with the service or investment options you have at one financial institution and can switch by means of a rollover to another financial institution.

You can move money in a Coverdell ESA between certain beneficiaries on a tax-free basis. The amount withdrawn from a Coverdell ESA can be rolled over to the same or a new designated beneficiary who is a member of the original beneficiary's family (listed in the next section). The rollover must be completed within 60 days. There are no tax consequences to naming a new designated beneficiary (as long as such beneficiary is permissible).

Pitfalls

If you contribute more than $2,000 on behalf of a beneficiary within one year, the excess amount is subject to a 6 percent excise tax. The penalty is paid by the beneficiary (not the contributor). But the penalty can be avoided by withdrawing the excess contribution, plus any earnings on the contribution, before the beginning of the sixth month following the year of the contribution (e.g., by May 31, 2004, for 2003 contributions).

The 6 percent excise tax continues to apply each year in which excess contributions (and earnings on excess contributions) remain in the Coverdell ESA.

Taxable distributions, which are withdrawals made to pay for noneligible expenses, are not only taxed as ordinary income but are subject to a 10 percent additional tax. However, the 10 percent penalty does not apply to distributions that meet any of these conditions:

• Distributions are made to a beneficiary or to the estate of a designated beneficiary on or after the death of a designated beneficiary.

• Distributions are made because the designated beneficiary is disabled.
• Distributions are made because the designated beneficiary received a tax-free grant or educational assistance allowance that equals or exceeds the distribution.

In 2003, Aunt Mary contributes $2,000 to a Coverdell ESA for Amy. Unaware of Aunt Mary's contribution, Uncle Ed also contributes $2,000 to a Coverdell ESA for Amy in 2003. Amy can avoid the 6 percent excise tax on the excess $2,000 contribution by withdrawing it, plus any earnings, by May 31, 2004. (Whether she chooses to give it back to Aunt Mary or Uncle Ed or split it between them is up to Amy.)

• Distributions are taxable only because the qualified expenses are reduced by expenses taken into account in figuring an education credit.

Withdrawals from a Coverdell ESA can be made in the same year in which an education credit is claimed. However, the same expenses cannot be used for both benefits.

Withdrawals from both a Coverdell ESA and a 529 plan are permitted in the same year. But if total withdrawals exceed qualified higher education expenses, the expenses must be allocated between the Coverdell ESA and 529 plan to figure the taxable portion of the withdrawals. Generally, the allocation is based on the ratio of the Coverdell ESA withdrawals to the total withdrawals.

Funds remaining in the account become taxable to the beneficiary within 30 days of attaining age 30 (or within 30 days of death if the beneficiary dies before age 30). The 30-year age limit does not apply to a special needs beneficiary (defined earlier).

However, tax on the earnings in the account can be avoided if the balance in the account is transferred to another eligible beneficiary within 60 days of attaining age 30 (or death if earlier). An eligible beneficiary for this purpose includes members of the beneficiary's family:

• Spouse.
• Child or stepchild.
• Grandchild.
• Brother, sister, half-brother, or half-sister.
• Niece or nephew.
• Parent or stepparent.

• Grandparent.
• In-laws and the spouses of any of the listed relatives.

Where to Claim the Exclusion

Contributions to a Coverdell education savings account are not reported on the return of the contributor or the beneficiary. Similarly, withdrawals that are not taxable are not reported on any return.

In 2003, Henry begins college and withdraws $800 from a Coverdell ESA and $3,200 from a 529 plan to pay $3,000 of eligible expenses. Of the $800 withdrawn, $600 is tax free: $800 Coverdell ESA withdrawal _ $4,000 total withdrawals = 0.2; 0.2 _ $3,000 qualified expenses = $600.

If contributions are subject to the 6 percent excise tax, the beneficiary figures the excise tax in Part V of Form 5329, Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts, and report it as “Other Taxes” on Form 1040.
If withdrawals from a Coverdell ESA are taxable, they are reported on the beneficiary’s return as “other income” on the return on Form 1040 or in the “Income” section on Form 1040A. If they are also subject to the 10 percent additional tax, this amount is figured in Part II of Form 5329, Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts.

4. Qualified Tuition Programs (529 Plans)

You can help save for the higher education expenses of your child or grandchild using a tax-advantaged account called a 529 plan. The 529 plan is a qualified tuition program offering federal (and in some cases state) tax incentives for savings.

Benefit

There are two types of qualified tuition programs (QTPs): a prepayment plan under which payments are guaranteed to cover (or partially cover) tuition, regardless of tuition increases, and a savings-type plan in which the funds you will have available to pay for higher education depend on the investment performance of your account. From a tax perspective, however, both types of plans are governed by the same tax rules under Section 529 of the Internal Revenue

Code (hence the name “529 plans”), and both types of plans have the same benefits and conditions.

While contributions to qualified tuition programs do not generate a federal income tax deduction or credit, the long-term benefits are considerable:

• Earnings within the plan are tax deferred.

• If funds in the plan are used to pay qualified higher education costs, they are tax free (the earnings on the contributions are never taxed in this case). In the case of distributions from private prepaid tuition plans, the exclusion does not apply until 2004.

• Unused amounts can be transferred tax free to another beneficiary if the original beneficiary does not go to college or otherwise need the funds.

There may be state income tax breaks for the contributions to qualified tuition programs as well. For example, if you are a resident in New York, you can deduct contributions up to $5,000 per taxpayer per year on your New York state income tax return.

Conditions

Most conditions and requirements are fixed by each state’s own 529 plan. However, for tax purposes, there are a couple of key conditions to obtaining all of the benefits under a qualified tuition program.

1. Contributions can be made only to qualified tuition programs. There are no federal tax limits on annual or total contributions to a 529 plan. These limits are fixed by each state’s unique program.

2. Distributions can be withdrawn only for qualified expenses.

QUALIFIED TUITION PROGRAMS. Contributions can be made only to state plans and IRS-approved private college/university plans. A personally devised plan, even one that mimics the investment strategies of the state plans, does not entitle you to these benefits.

At present, all states offer savings-type plans and nearly two dozen have prepaid tuition plans.

QUALIFIED EXPENSES. For distributions from qualified tuition programs to be tax free, they must be used only to pay for qualified expenses. These include tuition for higher education, fees, books, supplies, and room and board (if the student is enrolled at least half time).

There is no set dollar limit on these expenses, including room and board.

Thus, any reasonable amount for room and board (including expenses of offcampus housing) can qualify.

Planning Tips

The terms and conditions of qualified tuition programs vary considerably from state to state. You can learn about the investment options, fees, and other rules on state 529 plans at www.savingforcollege.com.

If you plan for your child to attend your alma mater on a legacy basis, ask the school whether it offers or plans to offer a tuition prepayment plan.

Qualified tuition programs can be used effectively for estate planning purposes. For example, a wealthy grandparent can reduce the size of his or her estate while funding an education savings plan for a grandchild with little or no gift tax cost. If you plan to make sizable contributions in one year, you can elect to treat the contributions as made equally over five years. This will entitle you to apply the annual gift tax exclusion five times to avoid or reduce gift tax.

If the contribution exceeds this limit, the excess amount is treated as a gift in the year the contribution is made.

Amounts in a 529 plan can be transferred to a new beneficiary or rolled over tax free within 60 days of a distribution. There is a limit of one transfer or rollover per year. However, a beneficiary can be changed without making a transfer or rollover; the new name is substituted for the old one on the same account. This option applies only if the new beneficiary is a member of the old beneficiary's family, which includes:

- Child or grandchild.
- Stepson or stepdaughter.
- Sibling or stepsibling.
- Parent or grandparent.
- Stepparent.
- Aunt or uncle.
- Niece or nephew.
- Son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law.
- The spouse of any relative listed above.
- First cousin.

In the case of a savings-type 529 plan, if the account declines in value from the amount contributed, the loss can be recognized when all of the funds in the account are distributed. The IRS says that the loss is claimed as a miscellaneous itemized deduction on Schedule A of Form 1040, which is deductible to the extent total miscellaneous itemized deductions exceed 2 percent of adjusted gross income. Some tax experts believe that the loss is simply claimed as an ordinary loss. This theory has yet to be tested in court.

Pitfalls

If funds are withdrawn from a 529 plan and *not* used for qualified education expenses, earnings on the distribution are taxable. For example, if part of a

In 2003, when the annual gift tax exclusion is $11,000 per beneficiary, you contribute $55,000 (or $110,000 per couple) to a state savings plan for your grandchild. Since you can treat the $55,000 as having been made ratably over five years, there is no taxable gift in this transfer. The transfer is fully offset by the annual gift tax exclusion ($11,000 x 5).

distribution is used for spending money or travel expenses, the earnings on this portion of the distribution are taxable.

In addition, the portion of the distribution representing earnings on contributions is subject to a 10 percent penalty.

Withdrawals from a 529 plan can be made in the same year in which an education credit is claimed, but the same expenses cannot be used for both benefits.

If withdrawals are made from a 529 plan and Coverdell ESA in the same year and the total withdrawal exceeds qualified education expenses, a portion of the withdrawal is taxable. How to figure the taxable portion was explained earlier in the Coverdell Education Savings Accounts section, under "Pitfalls."

Where to Claim the Exclusion

Contributions to qualified tuition programs need not be reported on the return of the contributor or the return of the beneficiary.

Distributions from qualified tuition programs need not be reported if they are tax free. To figure the tax-free portion of distributions, you can use a worksheet for this purpose in IRS Publication 970. For any year in which distributions are made, the 529 plan must send you (and the IRS) an information return, Form 1099-Q, Qualified Tuition Program. For distributions in 2003, the return must be issued no later than February 2, 2004 (January 31 is a Saturday).

5. Home Equity Loans

Equity is the amount of money you would receive, over and above any outstanding mortgage, if you were to sell your home today. Equity is built up in two ways: by paying down a mortgage on the home and by appreciation in property values. As your equity increases, you may be able to tap into it *without* selling the home by using a home equity loan. This loan may be the only loan on the property or it may be a second or even third loan in addition to any other home mortgage. The tax law allows interest on home equity loans to be deductible under certain conditions.

Benefit

You may deduct interest on home equity loans up to $100,000 if you itemize your deductions. There is no dollar limit on the amount of interest you can deduct (the limit applies to the amount of borrowing).

The rules for deducting interest on home equity loans apply to any type of home equity loan: a fixed home equity loan or a home equity line of credit with an adjustable interest rate. The deduction applies regardless of how you spend the proceeds (i.e., you don't have to use them for the home and can spend them in any way you desire, including paying off credit card debt).

Conditions

The same four conditions discussed for mortgage interest earlier (except for a smaller maximum amount) apply to deducting interest on home equity loans in full.

1. Total home equity debt cannot exceed $100,000. In measuring the $100,000 limit, take into account only the amount you've borrowed, not your potential borrowing under a home equity line of credit loan.

2. The debt must be secured by the residence.

3. The debt can apply to your main or second home.

4. You are personally obligated for repayment of the debt.

Planning Tips

If the amount of a home equity loan exceeds the $100,000 limit, you treat the interest on the first $100,000 as fully deductible mortgage interest. Interest on the balance of the debt may still be deductible under a tax rule other than home mortgage interest. The treatment of this portion of interest depends on what you use the proceeds for:

• If you use the proceeds to pay personal expenses (e.g., a vacation, credit card debt), it is nondeductible.

• If you use the proceeds to purchase investments (other than tax-exempt securities), you can treat it as investment interest. The rules on deducting investment interest are explained in Chapter 8.

• If you use the proceeds for your business, interest may qualify as fully deductible business interest, as explained in Chapter 15.

Pitfalls

In the case of a reverse mortgage, where a homeowner who is at least age 62 borrows against the equity in the home to pay personal living expenses and does not make mortgage payments (the lender recoups what is owed when the homeowner sells the home or dies), interest is deductible only when the loan is repaid. No deduction can be taken as the interest accrues each month on the outstanding loan.

While interest on home equity debt up to $100,000 is fully deductible for regular tax purposes regardless of what the loan proceeds are used for, such interest is deductible for purposes of the alternative minimum tax only if the proceeds are used to improve your main or second home.

Where to Claim the Deduction

You deduct interest on home equity debt on Schedule A of Form 1040. The amount of mortgage interest is reported annually to you by the lender on Form 1098, Mortgage Interest Statement.

You cannot claim the deduction if you file Form 1040A or Form 1040EZ.

6. Refinancing

When interest rates decline, homeowners with existing mortgages can obtain more favorable terms by refinancing. Generally, this means getting a new mortgage to replace the old one. But you may borrow more than you owe on your old loan if the equity in your home allows for such borrowing—to add a room, pay off credit card debt, fund a child’s education, or take a vacation. Under the tax law, the treatment of interest depends on what you use the excess funds for.

Benefit

With interest rates low, refinancing is a highly popular strategy to reduce monthly mortgage payments or obtain additional cash for various purposes. If your home has appreciated in value and/or you have paid down your mortgage, you may be sitting on substantial equity that you can tap by refinancing. You are not taxed on the equity you receive when you refinance your mortgage—the proceeds are tax free.

Whether and when interest on refinanced debt, as well as points to obtain the new loan, are deductible depend on the purpose of the refinancing (these rules are explained next).

Conditions

Your purpose in refinancing the outstanding debt on your home determines the tax treatment of the interest.

If you refinance your existing acquisition indebtedness, the new loan continues to be treated as acquisition indebtedness so that the interest is fully deductible (assuming the mortgage does not exceed $1 million). It does not matter whether you shorten or lengthen the term of the loan.

If you refinance your existing mortgage to take out equity you've built on in your home, deductibility of the interest on a new mortgage depends on what you do with the proceeds in excess of amounts used to simply refinance the existing debt.

If you use the excess proceeds to pay off credit card debt or other personal expenses, this portion of the debt is treated as home equity debt subject to the $100,000 limit. If the excess debt used for personal purposes exceeds this amount, a portion of your interest is nondeductible.

You bought your home 10 years ago for $100,000, using an $80,000 mortgage, which you've paid down to $72,000. Today your home is worth $225,000. If you refinance for $175,000 and use $72,000 of the proceeds to pay off the old mortgage, you can put $103,000 in your pocket tax free.

Your home today is worth $500,000 and the remaining balance of your old

mortgage is $200,000. If you refinance for $350,000 and use $50,000 of the proceeds to buy a personal car, take a vacation, and pay off some credit card debt, you can deduct interest on only $300,000 ($200,000 of acquisition indebtedness and $100,000 of home equity debt).

If you use the excess proceeds to substantially improve your home, such as remodel the kitchen or add a family room, interest on this portion of the debt, as well as the portion used to pay off the existing mortgage, is treated as acquisition indebtedness, which is fully deductible if the total does not exceed $1 million.

Planning Tip

If this is a subsequent refinancing (you've already refinanced your original acquisition indebtedness at least once), points paid on the prior refinancing become fully deductible in the year of your latest refinancing.

Pitfall

If you refinance, consider what term you want for the new loan. If, for example, you have been paying off a 30-year mortgage and have only 22 years remaining, when you refinance do you want to start the clock over again with a new 30-year mortgage? Maybe the answer is yes just to keep monthly payments as low as possible. But you may opt for a shorter term, such as 15, 20, or 25 years, so that you will pay off the mortgage at or about the same time as you had originally planned.

Where to Claim the Benefits

Since the equity you receive on refinancing for more than your old mortgage is not taxable income, you do not have to report it on your return.
You deduct home mortgage interest (including home equity debt and points)

Same as the preceding example except you use the $50,000 to add a family room to your home. Now you can deduct all of the interest on the new loan ($250,000 of acquisition indebtedness and $100,000 of home equity debt).

In January 1999, you refinanced your original mortgage and paid $3,600 for a 30-year loan. In January 2003, when interest rates have again declined, you refinance the outstanding balance of the 1999 loan. Of the points paid in 1999, you have already deducted $480 ($120 for 1999, 2000, 2001, and 2002). On your 2003 return you can deduct $3,120, the remaining amount of points on your 1999 refinancing.

on Schedule A of Form 1040. The amount of mortgage interest is reported annually to you by the lender on Form 1098, Mortgage Interest Statement.

You cannot claim the deduction if you file Form 1040A or Form 1040EZ.

7. Penalty-Free IRA Withdrawals for Home-Buying Expenses

If you thought IRAs were for retirement only, you'd be wrong. The tax law lets you tap into your IRA for certain special reasons without incurring any penalty (although withdrawals are subject to tax). One of those reasons is to buy a home.

Benefit

You may be able to use money in your IRA toward the cost of buying a home without incurring an early distribution penalty from your IRA. The withdrawal is subject to regular income tax, but you avoid the 10 percent early distribution penalty on withdrawals before age 59$\frac{1}{2}$.

Condition

You can only withdraw up to $10,000 free from penalty from your IRA. This is a once-in-a-lifetime opportunity. If you have already used this break to buy a previous home, you can't use it again.

You must spend the $10,000 on qualified first-time home-buying expenses, such as a down payment to purchase a home. These are expenses used to buy, build, or rehabilitate a main home for yourself, your spouse, child, grandchild, or ancestor (parent or grandparent) of you or your spouse. Such person cannot have had an ownership interest in a principal residence within two years before the purchase, construction, or renovation of the new home.

Planning Tip

Use this tax break only as a last resort. Once you withdraw the funds from the

IRA and spend them on home-buying expenses, you cannot replace the funds in your retirement savings account. In effect, you lose the opportunity to build up your retirement savings.

Pitfall

If you take a withdrawal from your IRA with the intention of using the money to buy a home but the sale falls through, you become taxed on the money unless you redeposit it back in the IRA. You have 120 days from your initial withdrawal to take this action.

Where to Claim the Benefit

If you take money from your IRA, you must file Form 5329, Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts. You report total early distributions from your IRA. You can then subtract those exempt from the 10 percent penalty because you used them for qualified first-time home-buying expenses. You must indicate on the appropriate line on the form which exception to the 10 percent penalty you are relying on (a number is assigned to each exception, and these numbers are listed in the instructions to this form).

Since you do not have any penalty on the distribution, you do not report anything in the section of Form 1040 for "Additional Taxes."

If you take money out of your IRA, you *must* file Form 1040 even if you are not subject to a penalty; you cannot file Form 1040A or 1040EZ.

8. Used Clothing and Car Donations

Clothing that no longer fits, appliances and sporting equipment that are no longer used, and cars being replaced may be of great benefit to someone else.

You own stock you paid $10,000 for years ago. It is now worth $2,000. If you donate the stock, your deduction is limited to $2,000. If you sell the stock and donate the proceeds, the charity receives the same $2,000. However, you can claim a tax loss of $8,000 ($10,000 – $2,000). You can use this loss to offset your capital gains and then up to $3,000 of your ordinary income; excess capital losses can be carried forward indefinitely and used in future years.

The tax law rewards donations of these items to charities that can put them to continued good use by permitting a tax deduction if certain conditions are met.

Benefit

Your old clothing, linens, toys, cars, and other items can be of benefit to others. Consider donating them to charity and taking a tax deduction for your efforts. You can deduct the value of the items you donate.
A deduction of these items generally is subject to the 50 percent of adjusted gross income limit discussed earlier in this chapter. This means that donations of these items are included along with your cash contributions to determine your annual limit.

Conditions

The items must be donated to a qualified charity (see the explanation of a qualified charity under "Cash Donations" earlier in this chapter).
You cannot claim a deduction if you donate items directly to an individual, no matter how much in need that person may be. For example, if a fire destroys a neighbor's home and you provide your neighbor with clothing and other items, you cannot claim a charitable contribution deduction for your generosity.

Planning Tip

Don't know what your used items are worth? Here are some resources you can turn to for help:
• Used cars: Kelley Blue Book at www.kbb.com provides free online prices for used cars, based on the vehicle's mileage, condition, and other factors.
• Used clothing: It's Deductible at www.itsdeductible.com is an online program you can use to find values for your items (there is a charge for this).

Pitfalls

The IRS advises caution when donating cars to charity. It recognizes that charities may use agents to handle the pickup and sale of the vehicles. But don't believe radio ads suggesting that you can receive a greater benefit by donating your car than by selling it. Since the value of your deduction is limited by your tax bracket, you can benefit from the donation only to the extent of your tax bracket.

You have an old car that is worth only $1,000. If you sell it you receive $1,000

(minus any selling costs such as advertising). If you donate it and are in the 28 percent tax bracket, the tax benefit of your donation is $280 ($1,000 x 28%).

Don't expect the charity to provide you with a valuation of your donation. It's up to you to assess the value of the items you donate; the charity merely confirms that you actually made the donation.
Generally charities that accept car donations through agents receive less than a few hundred dollars per car. If you want to benefit a charity to the fullest extent possible through a car donation, consider making a direct donation where it might do the most good. For example, consider donating your old clunker to a school with automotive repair classes where students may be in need of vehicles to work on.

Where to Claim the Deduction

For information about where to claim a deduction for your donation, see the rules under "Appreciated Property Donations" earlier in this chapter, including the rules on substantiation and filing Form 8283.

9. Hybrid Car Deduction

A hybrid car is a vehicle that runs on a combination of gasoline and electricity. Typically, the car starts in the gas mode and then runs on electricity, continually recharging itself. The federal government, as a way of encouraging these fuel-efficient vehicles, permits a tax deduction to be claimed for their purchase.

Benefit

If you buy a special clean-fuel vehicle powered by both gas and electricity, called a hybrid car, you may qualify for a tax deduction in 2003 of up to $2,000. This deduction can be claimed even if you do not itemize your other deductions. The one-time deduction applies only in the year in which you purchase the vehicle.

Conditions

Your car must receive special certification from the IRS that it is eligible for this deduction. To date, the IRS has certified the following vehicles:
• Honda Civic Hybrid (model year 2003)

• Honda Insight (model years 2000, 2001, and 2002)
• Toyota Prius (model years 2001, 2002, and 2003)

Ford, General Motors, Volvo, and other manufacturers are now working on hybrid vehicles, so ask your car dealer for other eligible models in the future.

Note: The $2,000 deduction applies to cars weighing no more than 10,000 pounds. Greater write-offs are available for heavier hybrid trucks and vans.

Planning Tips

If you are planning on buying a new car, factor in the deduction for hybrid cars when weighing the purchase price of cars under consideration. The write-off is designed to offset the incremental cost of the clean-fuel feature (it costs more to make a clean-fuel vehicle than an ordinary gas-powered one).

Also factor in the savings you will realize year in and year out when running a hybrid car. They get more than 60 miles to the gallon because they also run on electric power.

Pitfalls

Hybrid cars do not qualify for the tax credit for electric vehicles because they are not powered entirely by electricity.

You cannot claim the deduction if you lease a hybrid car; it applies only for purchases.

The deduction is reduced to $1,000 in 2005 and only $500 in 2006. No deduction can be claimed after 2006 unless Congress extends the law.

Where to Claim the Deduction

You claim this deduction in the "Adjusted Gross Income" section of Form 1040. There is no special line provided for this deduction. Simply enter it on the line used to total your adjustments to gross income and write "Clean fuel" on the dotted line. No special form or schedule is required.

You cannot claim this deduction if you file Form 1040A or 1040EZ.

10. Charitable Travel

Volunteering for your favorite cause may cost you money; just getting to and from your volunteer activity can be an expense. The tax law lets you deduct your out-of-pocket travel costs incurred for charitable pursuits.

Benefit

If you use your car for charitable purposes, including attending meetings of organizations you serve, you can deduct either your actual car expenses for gas and oil or mileage at the rate of 14 cents per mile. Whichever method you select, you can also write off parking and tolls.

You can also deduct travel expenses, plus meals and lodging, for overnight trips away from home to serve as an official delegate to a convention of a church, charitable, veteran, or other similar organization.

Conditions

You qualify to deduct your car expenses to the extent that the use of your car is for a tax-exempt organization or governmental unit. To see whether the charity you work for is tax-exempt, see Chapter 6.

You qualify for convention-related expenses that you are not reimbursed for if you serve as an official delegate on behalf of a religious, charitable, veteran, or other similar organization.

Planning Tip

Keep track of your mileage and out-of-pocket expenses on behalf of the charity. In a diary or logbook, note the odometer readings for every charity-related trip for which your car is used.

Pitfall

You cannot deduct travel costs to work on a project for a nonprofit organization if there is a significant element of personal pleasure, recreation, or vacation involved.

You cannot deduct travel costs to attend a charity-related convention if you do not serve as an official delegate.

Where to Claim the Benefit

To claim a charitable deduction for your charity-related travel expenses, you must complete Schedule A of Form 1040. Enter your deduction for charity-related expenses in the “Gifts to Charity” section of Schedule A.

You cannot deduct donations if you file Form 1040A or Form 1040EZ.

11. Gambling Losses

The American Gaming Association estimates that legal gambling is a $600 billion industry. Everyone knows that the odds always favor the house, whether it is a casino, race track, or state lottery. The chances of losing far outweigh those of winning. The tax law allows gambling losses to be deductible within limits under certain conditions.

Benefit

You can deduct gambling losses to the extent of your gambling winnings for the year. The losses do not have to result from the same gaming activities that produce the winnings.

If you are not a professional gambler, then gambling losses are claimed as miscellaneous itemized deductions, but they are not subject to the 2 percent of adjusted gross income floor that applies to most other miscellaneous itemized expenses.

If you are a professional gambler who devotes full time to this activity, you can treat your losses as a business expense. But even in this case gambling losses are limited to the extent of your winnings.

Conditions

You must report the gambling winnings that equal or exceed your claimed losses for the year. And you must have adequate records or receipts to prove your gambling expenses.

The Tax Court says that gambling winnings can include "comps" given to high rollers by a casino, such as a car, jewelry, and tickets to sporting events.

Planning Tip

Keep track of the amount you gamble throughout the year, since you don't know when in the year you will win. For example, retain all losing lottery tickets as proof of your gambling expenses so you can claim these losses when and to the extent you have winnings for the year.

Pitfall

Gambling winnings may be reported to you (and the IRS) on Form W-2G, Certain Gambling Winnings. If you claim losses in excess of amounts reported to the IRS, be prepared to show you had other winnings and that you reported these other winnings as income on your return.

Where to Claim the Deduction

If you are not a professional gambler, you claim a deduction for gambling losses in the space provided on Schedule A of Form 1040.

During 2003, you spend $20 every week to play bingo ($1,040 for the year) and you do not win anything. But in December 2003, you win $500 on a statesponsored scratch-off game, which you declare as income. In 2003, you can deduct $500 of your bingo losses; the other $540 of your gambling losses is not deductible, and cannot be carried forward to offset winnings in a future year.

If you are a full-time professional gambler, you can treat your gambling losses as a business expense. The wages must be placed only for your own account. Gambling losses in this case are reported on Schedule C or Schedule CEZ of Form 1040.
You cannot claim a deduction for gambling losses if you file Form 1040A or 1040EZ.

12. Rehabilitation Credit

Fix it up or tear it down? The tax law provides key incentives for restoring certain older properties. These incentives are tax credits that may be claimed if certain conditions are met.

Benefit

If you spend money fixing up an old building, you may be eligible to claim a tax credit. The amount of the credit depends on the type of building you renovate:
• Certified historic structures—20 percent of your expenditures.
• Buildings built before 1936—10 percent of your expenditures.
There is no overall dollar limit on the credit. However, there are certain limitations that may restrict the amount you can claim in the current year.

Conditions

Only certain buildings are eligible for the credit. They include:

• Historic structures
• Pre-1936 buildings

Regardless of which type of building is involved, you must expend a certain amount on rehabilitation in order to claim a credit.

HISTORIC STRUCTURES. The 20 percent credit applies to both residential or nonresidential buildings (such as industrial and commercial buildings). The only criterion is that the building is a historic structure, which is one that has been recognized by a national or state registry (placed on the National Register of Historic Places or located in a registered historic district and certified by the Secretary of the Interior as being of historic significance to the district).

The National Park Service must certify that your planned rehabilitation of the building is in keeping with its historic status designation.

PRE-1936 BUILDINGS. The 10 percent credit applies only to nonresidential buildings; you cannot claim a credit for fixing up your home or other residential building. In making renovations, you must retain a certain portion of the original structure (this rule prevents you from basically tearing down the old building to put up a new one).

More specifically, at least 75 percent of the external walls must be intact, with at least 50 percent kept as external walls. And at least 75 percent of the existing internal structural framework must be kept in place. One federal court allowed the credit to be claimed for a building that was moved to a new location and then renovated where at least 75 percent of the walls were retained as external walls after the relocation.

MINIMUM REHABILITATION. You can't claim the credit simply for adding a doorbell or making other minor renovations. The credit is limited to expenses of at least a certain amount: $5,000 or your adjusted basis in the building, whichever is greater.

The expenditures must be made within a 24-month period. This period is extended to 60 months if the rehabilitation is undertaken pursuant to a written architectural plan and specifications are completed before the rehabilitation begins.

Planning Tips

When shopping for real estate to purchase for investment or business, consider the impact that claiming the credit may have on your fix-up costs. Also explore any federal or state grants that may be available for restoring historic

structures (for example, see the Historic Preservation Grants program through the National Park Service at www.cr.nps.gov/hps/hpf/index.htm).
Check to see if there are state income tax credits or other incentives (such as real estate tax abatements) for rehabilitating certified historic structures or other old buildings.

Pitfalls

The tax credit for rehabilitating an old building falls under the passive loss rules. This means that the credit you are otherwise entitled to claim may be limited by passive activity restrictions. For more details, see the instructions to IRS Form 8582-CR, Passive Activity Credit Limitations.

You buy an old building for a cost of $50,000 (exclusive of the land). To claim the credit, you must spend at least $50,000 on renovations (since your basis of $50,000 is greater than $5,000).

You won't benefit from the credit if you are subject to the alternative minimum tax. This credit may not be used to reduce your AMT liability.

Where to Claim the Credit

You figure your credit on Form 3468, Investment Credit. The credit is part of the general business credit, which is figured on Form 3800, General Business Credit.
You may also need to figure whether the passive activity restrictions apply to your claiming the credit in the current year. You do this by completing Form 8582-CR, Passive Activity Credit Limitations.
The amount of the credit that can be claimed this year is then entered in the "Tax and Credits" section of Form 1040.
You cannot claim the credit if you file Form 1040A or 1040EZ.