SAVINGS BONDS: AN EDUCATION PLANNING TOOL

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ABSTRACT

The cost of a college education is expensive and rising. With diligent and vigilant planning, tax benefits can provide some relief from the high cost of college. The purpose of this article is to provide an overview of tax benefits available for education planning. Whether a taxpayer can take advantage of the credits, deductions, and savings programs described in this article depends on the taxpayer's individual facts and circumstances. Equipped with knowledge about the availability of tax benefits, a taxpayer in conjunction with a financial adviser should be able to develop a plan to mitigate the impact of education expenses.

INTRODUCTION

One of the major responsibilities that a parent faces is the cost of a child's college education. College costs are expensive and rising. Planning ahead for educational savings can provide tax benefits that relieve some of the high cost of a college education. The Technical and Miscellaneous Revenue Act of 1988 (TAMRA) provided the first incentive for educational savings with the addition of Section 135. Specifically, Section 135 provides that certain taxpayers can exclude interest on qualified United States Savings bonds from gross income, to the extent that the funds are used for qualifying education expenses (QEEs) for qualifying individuals. However, the exclusion is subject to several restrictions and limitations that limit its practical application. In this article, criteria for the exclusion, restrictions and limitations as well as an example of how to compute the interest exclusion will be discussed to provide an overview of the education savings bond program. All provisions, such as income phase out and annual limit, discussed relate to the 2008 filing year.

CRITERIA FOR EXCLUSION

Without planning, taxpayers can not utilize the incentive for the education savings bond program. To qualify for the interest exclusion, knowledge of the criteria that must be met is a necessity. In this section, the types of savings bonds that qualify, the categories of education expenses that qualify, and which individuals qualify will be discussed.

QUALIFIED UNITED STATES SAVINGS BONDS

A qualified U.S. Savings bond is a series EE bond issued after 1989 or a series I bond. The bond must be issued in the taxpayer's name (as sole owner), with or without a beneficiary, or in the name of both the taxpayer and the taxpayer's spouse (as co-owners). The owner or owners must be at least 24 years old before the bond's issue date. The issue date is printed on the front of the savings bond and is not necessarily the date of purchase. Paper or electronic EE and I bonds may be purchased from financial institutions or TreasuryDirect. (The electronic bonds are also referred to as book-entry savings bonds.)

Starting with 2008, $20,000 is the maximum amount in one calendar year that can be purchased of each combination. Therefore, in a calendar year, an individual may purchase the following: $5,000 (which is equivalent to $10,000 face amount) paper EE bonds, $5,000 electronic EE bonds, $5,000 paper I bonds, and $5,000 electronic I bonds. Currently, the rate for series EE bonds through October 31, 2008 is 1.4% fixed. Whereas, series I bonds have a rate of 4.84%. Due to the higher rate of interest, I bonds are currently the preferred funding source for exclusion of future interest. First offered in September 1998, I bonds are designed to ensure a real rate of return over and above the inflation rate.

QUALIFIED EDUCATION EXPENSES

The definition of QEEs for the interest exclusion provision includes only undergraduate and graduate tuition and required enrollment fees and payments to either a Coverdell education savings account (ESA) or a qualified tuition plan (QTP). Required tuition and fees incurred in connection with a course involving sports, games, or hobbies, however will not qualify unless the course is taken as part of a degree or certification program. QEEs do not include expenses for room and board.

QEEs must be reduced by the following amounts:

1. Tax-free part of scholarships and fellowships,
2. Expenses used to compute the tax-free portion of distributions from a Coverdell ESA,
3. Expenses used to compute the tax-free portion of distributions from a QTP,
4. Any tax-free payments (other than gifts or inheritances) received as educational assistance, such as
   a. Veterans' educational assistance benefits
   b. Qualified tuition reductions
   c. Employer-provided educational assistance, and
5. Any expenses used in computing the Hope and Lifetime Learning credits.

The QEEs must be incurred for enrollment or attendance at an eligible educational institution. An eligible educational institution is any college, university, vocational school, or other postsecondary educational institution eligible to participate in a student aid program administered by the Department of Education. Virtually all accredited, public, nonprofit, and propriety (privately owned profit-making) postsecondary institutions are included. Also, foreign schools that participate in the U.S. Department of Education's student aid program are eligible educational institutions. The educational institution should be able to inform parents if it is an eligible educational institution. If a parent has doubts about whether an educational institution is eligible to participate in a student aid program administered by the Department of Education, one source of information is located at http://www.fafsa.edu/gov.

QUALIFYING INDIVIDUALS

To take advantage of the interest exclusion, QEEs must be for a qualifying individual. A taxpayer, the taxpayer's spouse, or the taxpayer's dependents are classified as qualifying individuals. A quick test to determine if the individual qualifies is to answer the following question: Do you list the person's name on Form 1040 (or 1040A)?

RESTRICTIONS AND LIMITATIONS

The interest exclusion is subject to several restrictions and limitations. First, married taxpayers must file jointly. Second, the interest exclusion applies in the year the bond is redeemed. Third, any nontaxable distribution is limited to the amount that does not exceed QEEs. Fourth, the amount of the interest exclusion is gradually phased out if the taxpayer's modified adjusted gross income (MAGI) in 2008 is between $67,100 and $82,100 (between $100,650 and $130,650 if the taxpayer's filing status is married filing jointly or qualifying widow(er)). Finally, a taxpayer can not exclude any of the interest if their MAGI is equal to or more than the upper limit. When Form 8815 (Exclusion of Interest from Series EE and I U.S. Savings Bonds Issued After 1989, For Filers With Qualified Higher Education

Expenses) is completed, the amount of the phase out, if any, is calculated for the taxpayer. (See Exhibit 1 for an overview of the provisions of the education savings bonds program.)

Exhibit 1 ***Education Savings Bond Program***	
Applicable IRC Section	135
Benefit	Interest not taxed
Annual Limit	Amount of qualified education expenses
Income Phase Out	\$67,100 - \$82,100 \$100,550 - \$130,650 for joint returns
Qualifying Expenses Besides Tuition and Required Enrollment Fees	Payments to Coverdell ESA Payments to QTP
Qualifying Education	Undergraduate and graduate
Other Conditions	Applies only to qualified EE bonds issued after 1989 or series I bonds
Source: IRS [2007]; TAMRA [1988]	

AN EXAMPLE

Now, to demonstrate how the interest exclusion is computed, assume the following scenario. Bob and Mary, a married couple with a combined MAGI of \$90,000, bought an EE bond as co-owners in 1993 when they were both 35 years old. They cashed the EE bonds in 2008 to help pay for their daughter Ashley's college expenses. Ashley is their dependent. Pertinent facts regarding the EE bond and Ashley's 2008 college expenses are shown in Exhibit 2.

Ashley did not have any nontaxable educational benefits such as scholarships in 2008. She entered State University in August 2007, as a first semester freshman. In 2008, her tuition for the spring and fall semesters of 2008 was paid in the amount of $14,865.

The tuition of $12,865 ($14,865 total, less $2,000 used for the lifetime learning credit) was greater than the EE bond proceeds of $11,676, which included principal of $5,000 and interest of $6,676. (Bob and Mary must use both the principal and interest from the bonds cashed during the year to pay for tuition and fees of Ashley.) Therefore, the interest exclusion is $6,676.

To claim the exclusion, along with the lifetime learning credit of $2,000, Bob and Mary must file Schedule B (Interest and Ordinary Dividends), Form 8815 (Exclusion of Interest from Series EE and I U.S. Savings Bonds Issued After 1989, For Filers With Qualified Higher Education Expenses), Form 8818 (Optional Form to Record Redemption of Series EE and I U.S. Savings Bonds Issued After 1989, For Files With Qualified Higher Education Expenses), and Form 8863 (Education Credits, Hope and Lifetime Learning Credits).

Form 8818 should be completed for the taxpayer's records only. For each date that bonds are cashed, Form 8818 must be completed. Therefore, if the taxpayer makes four redemptions in one year, then there should be four Form 8818s. In lieu of completing Form 8818, records of the information on the form can be used. Information required includes the serial number, issue date, and face value of each bond sold. This information should be available from the financial institution where the bonds were cashed.

In the case where the redemption value including interest of the bonds is greater than the tuition and fees paid, the amount of the interest exclusion must be pro rated. For example, assume that EE bond proceeds were $15,500 in Exhibit 2. Then, the pro rata percentage of excludable interest is 83% ($12,865/$15,500).

Exhibit 2 ***Facts Regarding EE Bond and College Expenses***	
Purchase date of EE bond	January 1, 1993
Denomination of EE bond	$10,000
Purchase price of EE bond (50% of face value)	$5,000
Interest rate of EE bond	4%
Date the EE bond was cashed	July 5, 2008
Redemption value including interest	$11,676
Interest earned on EE bond	$6,676
Amount of Ashley's college tuition and fees paid by Bob and Mary in 2008	$14,865
Amount of tuition and fees used for lifetime learning credit	$2,000

CONCLUSION

Taxpayers have several options for educational savings, including the education savings bond program. With education costs increasing at all levels, taxpayers are advised to plan and utilize education tax incentives for educational savings. Whether a taxpayer can take advantage of the benefits of the education savings bond program described in this article depends on the taxpayer's individual facts and circumstances. However, equipped with knowledge about the education savings bond program, a taxpayer in conjunction with a financial adviser should be able to develop a plan to mitigate the impact of education expenses.

REFERENCES

Internal Revenue Service, *Tax Benefits for Education*, Publication 970 (2007).

Technical and Miscellaneous Revenue Act of 1988, Public Law 100-647 (1988).

AUTHORS

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