[Financial] REALITY BYTES:
NEW Tax Relief for Recent Graduates and Parents of College Students

For those Generation X'ers who complain about how life is unfair, you are absolutely CORRECT. Your parents in particular and boomers in general have had a much easier time paying for their college educations without taking out depressingly high amounts of student loans. **Yes, it bytes!** And, here's why.

Why Didn't My Parents Have More Debt?

A variety of factors are responsible for the escalating cost of attending college[1] and the increased use of student loans (as well as credit cards!) to pay for it.[2] More importantly, for our present interests, the federal tax reforms of the 1980s eliminated the deductibility of interest on student loans.[3] This is significant since the cost of your college education (especially if you go to graduate school) is most likely your second largest expense--after buying a home. Believe it or not, your parents could pay for most of their college expenses in the 1960s and 1970s through a combination of federal grants (about three-fourths of federal college aid was in the form of outright grants then!) and summer earnings. Furthermore, student loans were subsidized and the vast majority featured low interest rates--3 to 5 percent. In 1977, median student debt was about $2,000 and even this modest amount was reduced through the high inflation of the late 1970s and early 1980s.

Today, student loan levels are rising sharply as colleges and universities are responding to reductions in public funding by raising the cost of tuition. As shown in Table 1, tuition at American University in Washington, D.C. has risen more than seven-fold since 1975.

Table 1
SPIRALING COST OF HIGHER EDUCATION:
Undergraduate Room, Board, and Tuition at American University

Expenses	1975-76	1985-86	1995-96	2000-01
Tuition	$2,880	$8,200	$16,890	$21,144
Housing	$954	$2,400	$4,040	$5,350
Board	$588	$1,528	$2,800	$3,022
Total	**$4,422**	**$12,128**	**$23,730**	**$29,516**

Source: American University, Office of Financial Aid.

In fact, just tuition in 2000-2001 is greater than the total cost of attending this university for four years in the late 1970s! As a result, the debt levels of students enrolled in four-year institutions has jumped dramatically. Between 1990 and 1996, the median debt of college graduates more than doubled--from about $7,000 to over $15,000. Today, "college inflation" continues to rapidly outpace the general rate of inflation. So, are financial conditions more difficult for students today? You betcha! The KEY issue, then, is how to maximize the few financial tax advantages available to you and your financially stretched parents. Hey, look, if we can ease the financial burden on your parents then maybe they will share some of this newfound money with YOU! Just trying to help those strained family relations.

What's The Real Deal?

So, you ask, how does it work? Well, beginning with tax year 1998, **interest** on student loans can be deducted from your taxable personal income. Sorry, the loan "principal" or amount that you borrowed (including miscellaneous processing fees) does not count toward your tax deduction. The only condition that disqualifies you is if you are still claimed as a dependent on your parents' tax return. And, to legally qualify for this deduction, you have to have been making payments on your students loans since

1998. Also, **<u>you can currently claim as a tax deduction only the interest on the first 60 months</u>** (that's 5 years for the mathematically challenged!) of your student loan repayment period. Don't whine, that is when you pay most of the interest anyway. Of course, there are no retroactive tax benefits for those who graduated in the early '90s. Yes, it bytes, but you will have to fight that battle with the U.S. Congress. Don't try to kill the messenger of bad news!

The final qualifying condition is your taxable income. A maximum of $1,500 in student loan interest payments can be deducted from your 1999 Adjusted Gross Income **(AGI,** that is, after subtracting all of your tax deductions**)** if it totals less than $40,000 for those filing single tax returns and $60,000 for married couples filing a joint tax return; these income "brackets" are slightly higher in 2000 and 2001. And, the total deduction for interest paid on student loans rises to $2000 in 2000 and $2,500 for tax year 2001. Thank the U.S. Congress (It takes and gives back!) since it was only $1000 for 1998. <u>For those filing single returns,</u> this tax deduction is phased out between $40,001 and $55,000 Adjusted Gross Income. This means that as your <u>taxable</u> income increases over $40,000 (AGI), then the tax deduction declines until it is zero at $55,000 (AGI) in 1999. Hence, if you make $55,000 (AGI) or more in 1999, you do not quality for this new tax deduction. Of course, if you're making over 55 grand right out of college, you're not really concerned over a few hundred dollars, right?

<u>For those filing joint returns,</u> this tax deduction is phased out between $60,001 and $75,000 Adjusted Gross Income in 1999; these income "brackets" are slightly higher in 2000 and 2001. This means that if your combined taxable income exceeds $60,000 (AGI) in 1999, then the tax deduction declines until it is zero at $75,000 (AGI). For instance, if both spouses' income is less than $30,000, then you qualify for the full deduction. Similarly, if one spouse makes less than $60,000 and the other spouse does not receive monetary wages/salary, then you qualify for the full deduction. However, if the combined income of you and/or your spouse totals $75,000 (AGI) or more, then you do not quality for this new tax deduction. Note, <u>you do not qualify if you are married but are filing your tax return separately</u>.

How Do I Calculate My Income Tax Deduction?

Okay, so now I've got your attention. FREE MONEY has that effect on most people! Anyway, all you need to do is check **(1)** the interest rate of your student loans [CHECK carefully, you may have more than one interest rate!] and **(2)** the total amount of your student loans. Remember, you can **only claim as a federal tax deduction the first $1,500 in interest paid on your student loans in 1999 and $2,000 in 2000 rising to a maximum of $2,500 in 2001**. The U.S. Congress is not that generous yet--at least until you start voting in larger political "blocks." So, let's do the math. How do we calculate your interest deduction?

Let's suppose that after graduating in the spring of 1999 that you had the national average of about $17,000 in student loans. How much interest can you report as a deduction on your 1999 federal income tax return? For example, if they were low interest loans, say 5% Perkins loans, then you could report a deduction of only $850. If they were all 7% Stafford loans, then your total interest payments of $1,190 are still less than the maximum. If they were all private loans at 9%, then you paid $1,530 in interest--almost exactly the maximum deduction. A more serious challenge to your basic math skills occurs when you have several loans with different interest rates. For instance, suppose you had $7,000 in 5% Perkins loans and $10,000 in 7% Stafford loans. Your interest payments would be $350 (Perkins) and $700 (Stafford) or a total of $1,050--substantially less than the maximum allowable deduction! Or suppose you had $4,000 in 5% Perkins, $10,000 in 7% Stafford, and $3,000 in 9% private loans. Your total interest payments would be $200 (Perkins), $700 (Stafford), and $270 (private) or a total of $1,170. You get the idea. Of course, if you are carrying a heavier burden, the calculations are simple. For **tax year 2000**, the maximum student loan interest deduction of $2,000 is reached for 5% Perkins loans at $40,000, for 7% Stafford loans at $28,571 and for 9% loans at $22,222. For **tax year 2001**, the maximum student loan interest deduction of $2,500 is reached for 5% Perkins loans at $50,000, for 7% Stafford loans at $35,714 and for 9% loans at $27,778. See Table 2 for annual interest payments on loans from $5,000 to $50,000.

STUDENT LOAN INTEREST DEDUCTION:
Annual Interest Payments By Selected Interest Rate and Loan Total

TOTAL LOANS	Annual Interest Rate 5.0%	6.0%	7.0%	8.0%	9.0%
$5,000	$250	$300	$350	$400	$450
$8,000	$400	$480	$560	$640	$720
$10,000	$500	$600	$700	$800	$900
$12,000	$600	$720	$840	$960	$1,080
$14,000	$700	$840	$980	$1,120	$1,260
$16,000	$800	$960	$1,120	$1,280	$1,440
$17,000	$850	$1,020	$1,190	$1,360	$1,530
$18,000	$900	$1,080	$1,260	$1,440	$1,620
$19,000	$950	$1,140	$1,330	$1,520	$1,710
$20,000	$1,000	$1,200	$1,400	$1,600	$1,800
$22,000	$1,100	$1,320	$1,540	$1,760	**$1,980**
$25,000	$1,250	$1,500	$1,750	**$2,000**	$2,250
$30,000	$1,500	$1,800	**$2,100**	$2,400	$2,700
$35,000	$1,750	**$2,100**	$2,450	$2,800	$3,150
$40,000	**$2,000**	$2,400	$2,800	$3,200	$3,600
$45,000	$2,250	$2,700	$3,150	$3,600	$4,050
$50,000	$2,500	$3,000	$3,500	$4,000	$4,500

Needless to say, if you completed professional school where law students commonly graduate with a total of $60,000 in educational loans and medical students with more than $100,000, then this tax relief is a mere drop in the proverbial Tax Man's bucket. Do you think that student debt is contributing to rising fees for professional services?

So, is Uncle Sam going to give you $2,000 "cash back"--like the DISCOVER Card? No, not quite. These are income tax deductions that we are calculating. In the "real world," this means that your student loan interest payments can reduce your taxable income--up to a maximum of $2,000 per year in 2000--during the first five years of your loan repayment schedule. Remember, this student loan interest deduction rises to $2,500 beginning in tax year 2001. For instance, if you earned $12,500 in taxable income in 2000 then this deduction would reduce your personal income for taxation purposes to $11,000. Similarly, if you earned $25,000 in taxable income in 2000 then it would reduce your personal income for taxation purposes to $23,500 and if you earned $37,500 in taxable income then it would reduce your personal income for taxation purposes to $36,000. This is a very important distinction. The federal taxation rate for 2000 is 15% if your taxable income (unmarried) is under $26,251 while it rises to 28% if your taxable income is between $26,251 and $63,550. See the taxable income levels (after subtracting tax deductions) of the five major tax rate brackets, both single and joint (married) filings, in 2000.[4]

Now, drum roll please, the bottom line. If your annual earnings place you in the 15 percent federal tax bracket, then reporting a maximum $2,000 student loan interest deduction yields a tax saving or potential refund of $300; if you pay $2,500 in student loan interest in 2001, your tax saving will be $375. If you are in the 28 percent federal tax bracket, this represents a tax saving of $560; if you pay $2,500 in student loan interest in 2001, your tax saving will be a hefty $700. Remember, you are eligible for this tax deduction each year that you report student loan interest payments AND you earn less than the maximum single or joint income thresholds up to the first 5 years of your loan repayment schedule. And, remember, Uncle Sam is getting more generous. Can you spell budget S.U.R.P.L.U.S.? **The maximum student loan interest deduction was raised from $1000 in 1998, $1,500 in 1999, to $2,000 in 2000 and then $2,500 in**

2001! If you are lucky, maybe Congress will continue to increase the maximum deduction ($3,500 would be nice), length of loan repayment (why not 10 years!), and maximum allowable incomes (an additional $20,000 in annual income is more reasonable) before you pay off your student loans. By the way, will that be in 10, 15, or 20 years? You may wish to visit the module that examines the issues concerning the refinancing of student loans. Lastly, before we move on to your parents, it is important to note that you can claim this deduction without filing an itemized tax return. As you will soon learn, this is quite a computational convenience. So, don't whine about what you can't deduct. Enjoy what you can and "Just Do It!" Now, what's airfare to Cancun?

NEW EDUCATION-RELATED TAX DEDUCTIONS: For Mom and Dad

Okay, unless you hit the lottery or you have a full ride (all expenses paid) via an academic or athletic scholarship, the cost of college is a serious stress on mom and dad. And, I don't mean their worries over fraternity parties or dating. Let's not go there! When you become a parent, you'll know what I mean. Home equity loans, second mortgages, second jobs, pension loans, delayed retirement, etc. Kids today just don't understand the personal and financial sacrifices for them. Of course, did you at their age?! Anyway, Uncle Bill (as in President Clinton) is on your side and finally delivered some legislative relief that he promised to all those middle-class families that voted for him. By the way, he's sorry for those families whose children are finished with college but, at least he tried.

So, you're asking, HOW MUCH relief? Well, enough to make it worth your time. Here's how it works. Parents and other family members that pay for post-secondary educational expenses may qualify for the **Hope Scholarship** tax credit. This includes students enrolled in junior colleges, universities, and vocational training schools. The new tax credit permits you to claim up to $1,500 for tuition and other fees that were paid during each of the first two years of schooling per student--i.e., freshman and sophomore years. Beginning with the spring 1999 semester (January 1, 1999), you can claim 100% of the first $1000 and 50% of the second $1000 (or a maximum of $1500 per student) as long as they were enrolled in a degree granting program. There is, however, one important disqualifying condition. The Hope Scholarship tax credit can not be claimed for students with felony convictions relating to "controlled substances." That means if you get caught and it goes on your record, then your parents will pay too by losing this tax deduction. Do you hear that, slackers?!! Also, it is important to note that the credit is reduced by any financial scholarships that are received by the student. So, if you are in the 28% tax bracket and qualify for the maximum credit, this represents a tax saving of $420 for each of the two years. Otherwise, if you are in the 15% tax bracket, it represents a maximum tax saving of $225 per year. Lastly, the $1,500 maximum deduction will increase with the rate of inflation beginning with tax year 2002.

So, you are not overwhelmed by this government largess. Johnny pays more on parking fines and Suzy on a "day-trip" trip to the mall. Well, there is more. A second new tax break is the **Lifetime Learning** credit. You can qualify for up to 20% of the first $5,000 in education-related expenses that were paid after June 30, 1998 for students in their junior or senior year of college as well as those high achievers enrolled in graduate school. Hence, the maximum tax credit is $1,000 per year or $200 for each $1000 in educational expenses up to a total of $5,000. Significantly, this tax credit is phased out for individuals with taxable earnings between $40,001 and $50,000 Adjusted Gross Income (AGI); rising slightly in 2000 and 2001. For those filing joint tax returns, the education credit is phased out for those families with combined incomes that range from $80,001 to $100,000 (AGI). If you are in the 28 percent tax bracket and qualify for the maximum credit, this represents an annual tax saving of $280. Otherwise, if you are in the 15% tax bracket, it represents a maximum tax saving of $150 per year. And, beginning with tax year 2002, the tax credit rises to 20% of a total of $10,000 in educational expenses. Just remind your folks that every little bit helps!

There are no current limits on the number of students or years of supporting them in college so long as you can afford to pay for their expenses. In fact, Uncle Sam allows you to "double your pleasure" with these two new tax deductions if you are paying for two or more college students. Please note, however, that you can **NOT** claim both the **Hope Scholarship** and the **Lifetime Learning** tax credits in the **same** year for the **same** student. If you are paying for two different students (these credits apply to the financial support of other family members as well), you can claim a **Hope Scholarship** credit for one and a **Lifetime Learning** credit for the other. Please note that you are required to use **Form 8863** but do not need to file an itemized tax return. So, a substantial return on a minimal investment of time. Of course, as you know, every little bit helps. And, what a surprise when it comes from the Feds![5] We suggest that you invest these unexpected savings in your IRA and maybe you can retire a year early! After all, you're not going to rely on junior to help pay for those unexpected expenses during your Golden Years, are you?

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[1]See Robert D. Manning, "CREDIT CARDS ON CAMPUS: Social Costs and Consequences of Credit Card Debt," (June 1999) which reviews the rapidly increasing expense of attending college at public and private four-year institutions. This report is available in the "RESEARCH REPORTS" section of this Web site. Also, these issues are examined in Robert D. Manning, Credit Card Nation, Chapter 6, (New York: Basic Books, 2000). For other studies on this topic, see publications by The Education Resources Institute [TERI] and The Institute for Higher Education Policy: Graduating into Debt (1995); College Debt and the American Family (1995), and Student Loan Debt: Problems & Prospects (1998). Their respective web sites are: **www.teri.org** and **www.ihep.com.**

[2] These factors include the sharp decline in public funding of colleges and universities (How do you think we paid for the "Star Wars" programs?!!), shift in federal student aid from grants (free money for college) to loans (government pays for the insurance on subsidized and unsubsidized Stafford student loans), rising cost of college tuition (although universities are squeezing you harder than ever, you don't feel it since the financial pain of loans and credit cards is postponed until after graduation), student wages have fallen sharply due to inflation over the last two decades, and the middle-class "squeeze" means that American families are less able to save for their children's college expenses.

[3] After the U.S. Congress enacted various corporate tax "relief" reforms in the 1980s (especially the 1982 and 1986 legislation)--read generous tax deductions and corporate tax loopholes--the percentage of corporate revenues that were paid in the form of taxes declined in this period. In comparison, the federal income tax "bite" on middle class workers was reduced in terms of percentage rates but the average income taxes paid my the middle class rose in the 1980s and 1990s. This is because inflation pushed more people from the 15% to the 28% federal income tax "brackets," local taxes increased (sales, property, county and state income taxes) due to shrinking federal revenue sharing monies (if you live in New Jersey, you know what we mean!), a sharp rise in employer-employee required Social Security "contributions" (the largest federal "back

door" tax of the 1980s), and fewer allowable tax deductions such as interest paid on credit cards and auto loans.

In essence, corporate taxes were reduced over the last two decades while total personal income taxes increased substantially for middle class families. Ironically, this is one of the most enduring legacies of the "Reagan Revolution"--the regressive impact of its anti-tax policies. For instance, households can no longer deduct the finance charges accruing from their credit cards but Citicorp can still deduct all of the finance charges and other costs associated with its 1998 merger with Traveler's Bank.

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2000 TAXABLE INCOME RATE "Brackets"

Unmarried, Filing Single Tax Return:

15%	28%	31%	36%	39.6%
-$26,250	$26,251-$63,550	$63,551-132,600	$132,601-$288,350	Over $288,350

Example

How much would a single wage-earner (no, full-time students are not considered "workers") pay if his/her federal taxable income (after subtracting all itemized deductions such as student loan interest) is $23,000? You can go to the Debt Zapper to calculate yourself. Otherwise, trust us with the following calculations: 15% percent of $23,000 or $3,450. Now, suppose you received that big promotion from assistant to manager with a hefty salary increase to $42,500. The total federal tax obligation of this would be 15% of the first $26,250 or $3,937.50 and 28% of the remaining $16,250 or $4,550. The total federal tax obligation would be $8,487.50 or $3,937.50 + $4,550. If salary and bonuses increase your total to $80,000, the tax bite is even more complex to calculate. The total federal tax obligation would be 15% of the first $26,250 or $3,937.50 PLUS 28% of the next $37,299 or $10,443.72 PLUS 31% of the remaining $16,449 or $5,099.19 for a GRAND TOTAL of $19,480.41. And, this total does not include Social Security "contributions." Do you know how many months of paychecks you need to pay all of your taxes? What a bite after federal, state, local, sales, and Social Security payments! What if you make over $133,000? Well, you'll be able to hire a very competent accountant to minimize your tax "obligations." Hey, maybe you'll send a donation to the Steve Forbes Presidential campaign--remember his "flat tax" proposal?

2000 TAXABLE INCOME RATE "Brackets"

Married Individuals Filing Joint Tax Return:

15%	28%	31%	36%	39.6%
-$43,850	$43,851-$105,950	$105,951-$161,450	$161,451-$288,350	Over $288,350

Example

How much would two married individuals pay if their combined federal taxable income (after subtracting all itemized deductions such as mortgage interest on their residential "castle") is $38,000? You can go to the Debt Zapper to calculate yourself. Otherwise, trust us with the following calculations: 15% percent of $38,000 is $5,700. At $57,000 (approximate median family income with two wage earners), is 15% percent of the first $43,850 or $6,577.50 and 28% of the remaining $13,150 or $3,682. The total federal tax obligation of this married couple would be $10,259.50. And, if their combined income is $120,000? Follow the floating decimal point: 15% percent on the first $43,850 or $6,577.50 PLUS 28% for the next $62,099 or $17,387.72 PLUS 31% of the remaining $14,050 or $4,355.50. The Grand Total federal income tax is--drum roll please--$28,320.72. Now you know where the $$$ comes from to pay for those Billion Dollar B-1 bombers!

2000 TAXABLE INCOME RATE "Brackets"

Head of Household Filing Tax Return:

15%	28%	31%	36%	39.6%
-$35,150	$35,151-$90,800	$90,801-$147,050	$147,051-$288,350	Over $288,350

Example

Now, if you are the head of household without a wage-earning spouse or companion, note that the tax "burden" is less than a single wage earner. This is due to the added cost of supporting "unproductive" members of the household--e.g. dependent slackers. And, no, you can not file as a head of household by claiming as dependents your goldfish or a "quad" dog. So, what would be the federal tax (after subtracting all itemized deductions such as dependent children or student loan interest) on an annual income of $25,000? You can go to the Debt Zapper to calculate yourself. Otherwise, trust us with the following calculations: 15% percent of $25,000 or $3,750. Now, what if you received that big promotion from sales clerk to purchasing agent with a hefty salary increase to $55,500. The total federal tax obligation of this would be 15% of the first $35,150 or $5,272.50 PLUS 28% of the remaining $20,350 or $5,698. The total federal tax obligation would be $10,970.50 or $5,272.50 + $5,698. Now, if you rise to Vice-President, with a salary of $125,000, the total is even more complex to calculate. The total federal tax obligation would be would be 15% of the first $35,150 or $5,272.50 PLUS 28% of the next $55,649 or $15,581.72 PLUS 31% of the remaining $34,199 or $10,601.69 for a GRAND TOTAL of $31,455.91. And, if you become the President of the company with a salary of $250,000? Well, make sure that your contributions to "campaign reform" and other Political Action Committee (PAC) activities are tax deductible! Your company accountant will know for sure.

2000 TAXABLE INCOME RATE "Brackets"

Married Individuals Filing Separate Tax Return:

15%	**28%**	**31%**	**36%**	**39.6%**
-$21,925	$21,926-$52,975	$52,976-$80,725	$80,726-$144,175	Over $144,175

Example

So, you and the Mister make a "comfortable" combined income and decide to file separate tax returns. What do you think about the federal "marriage tax"? Anyway, you have probably figured it out how to calculator your tax "bite" by now. You've followed the program, been there and done that with the "Debt Zapper" calculator. Okay, let's do the drill for the final time. Suppose your husband was on paternity leave and only worked part-time last year with a net income (after subtracting all itemized deductions such as student loan interest) of $17,500. At a tax rate of 15% percent, the federal tax obligation is $2,625. Now, suppose that after returning to full-time employment, the annual taxable income was $35,000. This would increase the total federal tax obligation to $6,949.47. That is, $3,288.75 for 15% of the first $21,925 PLUS $3,660.72 or 28% of the remaining $13,074. And, with that job at the big law firm, a net income of $70,000 (after subtracting all itemized tax deductions) would yield a federal tax "bite" of $17,259.91. That is, $3,288.75 for 15% of $21,925 PLUS $8,693.72 or 28% of the next $31,049 PLUS $5,277.44 or 31% of the remaining $17,024. If you are promoted to partner, with a $140,000 salary, your secretary is probably reading this. Tell your boss that our charge to estimate your taxable income is negotiable at 5 minute billable increments.

(Have an old version of this module and don't want to "upgrade"? Go check the tax bracket updates at **www.taxplanet.com.** See, we don't do this for the $$$.)

[5] The Internal Revenue Service (IRS) has been mandated by the U.S. Congress to become "user friendly" service providers to those of us that pay their salaries--a radical concept in the federal bureaucracy! And, these public servants seem to be taking this directive seriously. Straight up! They are nice on the phone and if you have any questions, feel free to call them at 1 (800) 829.1040. Also, order "Tax Benefits for Higher Education" (Publication 970) if you have more detailed questions. It is well organized and indexed. And, **it's free!** Also, for you internet mavens, check out the IRS web site for up-to-the-minute modifications in federal tax statutes. I know, exciting reading. But, hey, some of you want to be accountants and tax lawyers. Maybe perusing this site will lead to a life defining experience and you will find your true niche in organic vegetable farming. I know, its a stretch, but you get the idea. The IRS web site is http://www.irs.ustreas.gov.