

Education Credits – Regulations

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Corrections and Clarifications:

Coverdell ESA: The discussion of Section 529/530 was unclear in a previous version of this article. The computer expense for family and beneficiary is only good for elementary and secondary education (Section 530).

Computer expense for family and beneficiary was a qualified **higher education** expense for 2009 or 2010 only. Section 529(e)(3)(A)(iii), 530(e)(3)(A)(iii). Other comments concerning Coverdell and IRAs were also added to the text.

This article describes the IRS tax code and regulations covering education credits with a focus on the American Opportunity Tax Credit. It particularly considers regulations that allow taxpayers to claim the credit even though they might not be out-of-pocket for any of the expenses.

This is one in a series of articles I've written on how to claim education credits. One version of this article was posted on the blog, [Switched Keys](#). The articles and other resources are part of an AOTC toolkit that can be downloaded from www.tylerhosting.com/EdCredit/. Comments, questions, and corrections are welcome and can be submitted through the contact form on the blog.

AOTC Toolkit

- Education Credit Regulations: A discussion of the AOTC and the regulations that permit inclusion of grants and scholarships to increase qualifying expenses and the credit. Coordinating with other education programs is also discussed.
- Education Credit Preparation: Specific instructions for accessing and retrieving expense information from local institutions UT Tyler and TJC.
- Education Credit Calculations: A method for tabulating qualifying expenses and calculating the credit. Includes the spreadsheet version of the AOTC worksheet.
- AOTC Flowcharts: The Student Qualifications Test assists in determining if the taxpayer qualifies for the credit. Same chart as published by the IRS. The Refundable Credit Test helps determine if the taxpayer qualifies for the refundable portion of the AOTC. Instead of the IRS outline of those who **do not qualify**, this flowchart identifies those that **do qualify**.
- AOTC Worksheet: The AOTC worksheet assists in maximizing the AOTC qualifying expenses and calculating the amount of taxable scholarships. Includes examples from IRS publications and regulations. Not the same as related IRS published worksheets.

Introduction

Education credits have been around for some time, but there does not seem to be enough emphasis on them, and too much misinformation about them. I hope this encourages more practitioners to take education tax credits and benefits more seriously. There are a dozen credits and deductions available on your individual tax return but the most valuable are the two credits – the American Opportunity Tax Credit (AOTC) and the Lifetime

Learning Credit (LLC). Although I mention a few other education options, and the need for planning, this set of articles focuses on the AOTC.

Missing Credits

The focal point in tax preparation of returns with education expenses has traditionally been on the tax-free nature of scholarships and grants. However, when practitioners are preparing returns for students, or parents of students, they should not assume everything balances out if the client didn't actually make payments to the college. Commonly overlooked by individuals and practitioners alike is the fact that student loans are amounts that the student pays for qualified expense, and they consequently qualify for education credits. Even if loans are not a part of the funding, taxpayers may qualify for the credit when they are not out-of-pocket for any of the expenses

Practitioners should also education credits a second thought when considering the impact of scholarships and grants received, even if they balance out with expenses. Depending on the type of scholarship, they may need to consider the potential benefits of Treas. Reg. 1.25A-5, which enables taxpayers to include some scholarships in income and increase amounts qualifying for education benefits. The regulations include several examples which have been included in Pub 970.

Another common assumption is that scholarships are always tax-free, and that they must be used first to reduce qualified educational expenses with only the remaining expenses available for calculating the education credits. That is not true.

While many people are aware of the AOTC, it is plagued by misinformation and false assumptions. That misinformation has even been perpetuated by companies like H&R Block¹ and Intuit², and by financial aid departments of colleges and universities. Even tax software publishers are not well informed. The TaxSlayer support site notes, "You can only receive a deduction or credit for the amount of expenses that you paid **out of pocket**³.

In many cases, however, taxpayers may be missing the credit due to a lack of effort, either on the part of the taxpayer or the preparer. Qualifying for the credit requires getting account information on which to calculate the credit. Maximizing the credit may also require researching the terms of the scholarship. Furthermore, calculating the expenses for the credit, payments and the amount of taxable scholarships may be confusing or time-consuming.

Because of that lack of research and the prevalence of misinformation concerning education credits many taxpayers are missing credits they could easily qualify for. Analyzing the potential of an education credit should become a routine part of preparing returns for individuals with educational expenses. Because current software doesn't generally guide taxpayers in maximizing potential education credits, practitioners may have to put in a little extra effort to insure that the client gets his reward.

¹ http://www.hrblock.com/tax-answers/services/jsp/article.jsp?article_id=67005

² <https://ttlc.intuit.com/questions/1901069-are-scholarships-fellowships-and-grants-considered-taxable-income>

³ <https://www.taxslayer.com/support/knowledgebasearticle206.aspx>

Background

Two popular education credits that will still be available for the next few years include the American Opportunity Credit (AOTC) and the Lifetime Learning Credit (LLC). The AOTC is a credit for up to \$2,500 of \$4,000 for qualified educational expenses, with 40% of that allowed as a refundable credit. The AOTC is also referred to as the Hope Scholarship, although the original Hope scholarship was limited to the first two years of college. The American Opportunity Tax Credit is the title of IRS Code Section 25A(i) that describes changes to the Hope Scholarship so both reference the same credit. Lower income taxpayers are likely to use the American Opportunity Credit since it does not require taxable income for the refundable part of the credit.

The LLC is a credit of 20% of up to \$10,000 of eligible educational expenses. The key differences in the two are that part of the AOTC may be refundable while the LLC is not, and the AOTC is only available for students seeking a degree/certificate while the LLC is available for all education used to acquire or improve job skills. There are some other minor differences between the two as well.

Taxpayers must choose between the LLC and the AOTC however, as they cannot claim both credits for the same student. Also, if either credit is used, the tuition deduction is not allowed for that student. You can, however, claim the AOTC for one student and the LLC for another. There are also phase-outs for both credits.

There is a maze of other educational benefits that are available which may be more advantageous depending on the taxpayer's income level, tax bracket and other circumstances.

Qualifying Expenses

Both credits apply to qualified education expenses, although there is a slight difference there as well. For the AOTC qualifying expenses include costs of tuition and required fees, as well as required books. The books do not have to be purchased at the institution. Room and board is not qualifying for the AOTC, but it is for some other financial aid, so it may be necessary to coordinate with other allowances to receive the maximum benefit.

American Opportunity Tax Credit

Who qualifies?

The qualifications for the AOTC relate more to the student than the taxpayer. If the student meets the qualifications then the taxpayer qualifies to claim the credit. Some of the qualifications for the AOTC include.

- Student must be pursuing an undergraduate degree or other recognized education credential
- Student must be enrolled at least half time for at least one academic period beginning during the year
- No felony drug conviction on student's record
- Available for first 4 years of post secondary education
- Cannot be claimed more than 4 tax years.

Refundable Qualifications

Additional qualifications exist for the refundable portion of the credit. See Section 25A(i)(5) and references for specific details. Students age 24 and over qualify for the refundable portion of the credit, as well as parents of

children under the age of 24 if they claim the child as a dependent. Taxpayers can use the IRS Interactive Tax Assistant at <http://www.irs.gov/uac/Am-I-Eligible-to-Claim-an-Education-Credit%3F> to see if they qualify.

The credit is attached to the dependency, so if the parent claims the AOTC for a child, the child will not be able to claim his own exemption. Recent proposals have suggested that the qualifying age be reduced to 21, so a review of current laws may be appropriate.

While many students under the age of 24 do not qualify for the refundable portion of the credit, it is important to review the regulations that apply to each case as there are several exceptions. Filing a joint return or when both parents are deceased are two cases where a student under age 24 could qualify. Students that are age 18 and over may also qualify if they provide more than half of their support through earned income, or if they are only attending part-time.

Publication 970 provides these qualifications.

You **do not** qualify for a refund if items 1 (a, b, or c), 2, **and** 3 below apply to you.

1. You were:
 - a. Under age 18 at the end of the tax year, **or**
 - b. Age 18 at the end of the tax year **and** your earned income (defined below) was less than one-half of your support (defined below), **or**
 - c. Over age 18 and under age 24 at the end of the tax year **and** a full-time student (defined below) **and** your earned income (defined below) was less than one-half of your support (defined below).
2. At least one of your parents was alive at the end of the tax year.
3. You are filing a return as single, head of household, qualifying widow(er), or married filing separately.

It is important to notice the ands and ors, and verify any information to the contrary. It may be more useful if the qualifications show who does qualify. Changing some terms and the ands and ors, you can use the following outline.

You **DO** qualify for a refund if items 1 (a, b, or c), 2, **or** 3 below apply to you.

1. You were:
 - a. Age 18 at the end of the tax year **and** your earned income (defined below) was at least one-half of your support (defined below), **or**
 - b. Over age 18 and under age 24 at the end of the tax year **and** not a full-time student (defined below), **or**
 - c. Over age 18 and under age 24 at the end of the tax year **and** your earned income (defined below) was at least one-half of your support (defined below), **or**
 - d. At least age 24.
2. Neither of your parents was alive at the end of the tax year.
3. You are filing a joint return.

Note that the tax code defines those who do not qualify through a series of referrals. Code section 25A indicates that the refundable credit is not available to a child to whom Section 1(g) (Kiddie tax) applies, which refers to Section 152(c)(3). Although 152(c)(3) includes simply a student under 24, the definition of student in this section is a full-time student as defined in 152(f)(2)(A).

What are qualifying payments?

Payments for qualifying expenses include amounts paid by the student, or by the parents for the student, or paid through student loans. Also qualifying are payments made by a third party that are in the nature of a gift. So if the grandparent pays for part of the cost of attending college, the student (or parents) can claim the credit using those amounts.

Lifetime Learning Credit

The LLC has none of the previously mentioned requirements for the AOTC. Instead, the LLC can be claimed on qualifying expenses for any education that helps a student acquire or improve a job skill. It does not require a degree credential, does require half-time attendance, and isn't limited by a drug felony conviction. But the LLC is not refundable, and the credit is only 20% of expenses. Other differences also exist. Whether you use the LLC or decide to take a deduction may depend on your marginal tax rate.

Coordinating Scholarships and Grants to Maximize Credits

It may be possible to qualify for or increase the amount of both the AOTC and the LLC by including some scholarships and grants in income. This is largely dependent on the type of scholarship or grant. The definition of different types of scholarships may cause confusion in evaluating possible treatment. Section 117 defines qualified scholarships as **any amount** of a scholarship used for qualified expenses. However some scholarships can be treated as taxable or non-taxable based on the terms of the scholarship as outlined in Regulation 1.25A-5(c)(3)⁴. The regulation also includes multiple examples illustrating the potential effects of considering scholarship taxable income. For tax purposes, grants follow the same logic as scholarships.

Three Types of Scholarships

The tax code only describes taxable and qualified (or tax-free) scholarships, and qualified scholarships only describe **amounts** of a scholarship that are used to pay qualified expenses. In order to better understand the types of scholarships in regards to tax treatment, I define scholarships here as exclusive, taxable, or elective. Briefly, exclusive scholarships cover only qualified expenses, taxable scholarships cover only non-qualified expenses, and elective scholarships may be used to cover qualified or non-qualified expenses. The elective nature of the third type is what enables us to re-allocate scholarship amounts, increasing qualified expenses to achieve the highest credit amount.

Exclusive Scholarships

Exclusive scholarships are those scholarships, by the terms of scholarship, which must be used to pay qualified

⁴ <http://www.law.cornell.edu/cfr/text/26/1.25A-5>. Accessed 11/6/2014.

expenses. The full amount of the scholarships must reduce the amount of qualified expenses. Because the scholarship must be used for qualified expenses, no amount should be refunded. A refund, however, may not change the terms of the scholarship.

Taxable Scholarships

A scholarship that **must be used** exclusively for **other than** qualified expenses is taxable, but not considered earned income. It is reported on line 7 as scholarship income with other taxable scholarships. Room and board is not a qualifying expense, so scholarships that cover only that is *normally* taxable. Scholarships in excess of qualifying expenses are also treated as taxable scholarships.

As you will see next, some scholarships can be **treated** as taxable scholarships.

A scholarship that pays students for services they must perform, such as teaching or research, are taxable and reported as earned income on a W-2. They should not enter into the calculation of education credits.

Double requirements

Some scholarships may be required to be used for a combination of qualifying and non-qualifying expenses, for example, tuition and room and board. These scholarships would be part exclusive and part taxable. If that is the case, the amount must be allocated between the two amounts.

Elective Scholarships

The third type of scholarship is the elective scholarship. The term elective is not defined in the code as such but the concept is taken from Regulation 1.25A-5(c)(3) where scholarship amounts can be treated as either taxable or tax-free. The concept is also published in IRS Publication 970. The phrase that separates exclusive from elective in this context is "used for other than qualified expenses." If a scholarship **may** or **must** be used for other than qualified expenses you can elect to include it in income, or treat it as tax-free and offset qualified expenses. When treated as income, the amount of qualified expenses is not reduced and the taxpayer may qualify for a higher education credit.

Pell grants

Scholarships that are available for elective treatment include Pell grants. In fact, determining if other scholarships are elective will often not be necessary. Pell grants may often be \$4000 or more of the aid received by the student, the maximum amount considered in calculating the AOTC. The LLC expense limit is \$10,000. Most other federal aid, as well as Coverdell Educational Savings Accounts are also considered elective scholarships.

Other elective scholarships

If it's necessary to consider the elective nature of other scholarships research will be necessary, but that research outlay can be used on multiple returns. A practitioner that researches area scholarships in advance can quickly answer questions about the elective nature of particular scholarships. A repository of information related to these scholarships will be invaluable during tax season. Finding out if scholarships can be taxable can

be a formidable task, however.

All of the circumstances should be weighed when determining if a scholarship, grant, or other source is evaluated for possible treatment as an elective scholarship suitable for maximizing the education credits. However, some key words to look for are "room and board", "living expenses", and "excess refunded".

Scholarships that are merely based on the "amount of" tuition instead of "used for" tuition may also be considered elective scholarships. Just because a scholarship is based on the costs of tuition does not mean it is limited to tuition costs.

In an IRS ruling related to the Louisiana Tuition Opportunity Program for Students (TOPS) program in Louisiana, it was determined that the TOPS awards could be applied to Section 25A and 117 in determining tax treatment. In 1999 the Louisiana legislature went from a system that required a TOPS award to **be used** for tuition to a system that **measures** the amount of the award **by** the amount of tuition.

Although the ruling cannot be used as precedent, it is a logical assumption that the recipient could use the funds for other expenses. The TOPS ruling confirms that (then proposed) Reg. § 1.25A-5(c)(3) allows this grant to be considered a "qualified scholarship excludable from income under section 117" unless:

- (i) The grant is reported as income on the taxpayer's federal income tax return, or
- (ii) The grant must be applied, by its terms, to expenses other than qualified tuition and related expenses within the meaning of section 117(b)(2), such as room and board."⁵

On the other hand, the Texas Hazlewood Exemption for Texas veterans would not be considered elective because of its strict regulation that amounts are for tuition and required fees, and because it is an exemption rather than an amount provided to the taxpayer.

As more taxpayers take advantage of Regulation 1.25A-5(c)(3), the IRS may issue other regulations clarifying what constitutes elective scholarships.

Local Research Examples

I haven't been able to acquire legal documents that spell out the terms of scholarships at local institutions. There are, however, official representations of the terms of several popular scholarships in Tyler institutions' websites. In most of the UT Tyler scholarships, the first item describing the requirements is "Award may be used for the payment of tuition, fees, books and supplies at UT Tyler only." and then there is an addition that "Any remaining funds will be disbursed on the published financial aid disbursement date." If you apply logic, it seems to allow you to use remaining funds for personal expenses, and thus it may be used for other than qualified expenses. Fortunately, you don't have to twist any words here. The UT Tyler Scholarship FAQ page confirms:

Q: Will scholarship awards apply to tuition, fees, books, supplies, and housing?

A: Yes, up to the value of the award.

Q: If I have monies left over on my account after everything is paid, will I get those monies?

⁵ PLR 200137006.

A: Yes... Remaining funds will be refunded....⁶

I suspect such elective scholarships are more common today because institutions don't want to keep track of whether you use the resources for qualified expenses. Everything is grouped together, tuition and fees are paid, and the excess is refunded. However, it is best to find something that says so.

Federal grants are another common source of financial aid. Most federal aid, including the Pell Grant, are need-based, and since the term "need" includes food and a place to stay, you might conclude that they may be used for other than qualified expenses. Again you don't have to wrangle with that.

Q6. What costs does a Federal Pell Grant cover?

A6. Federal Pell Grants are available if you are taking classes as part of a program that leads to an undergraduate degree or certificate. Federal student aid, including Pell Grants, can be used to cover a variety of costs, generally including

Tuition and fees normally assessed;

Books, supplies, transportation, and miscellaneous personal expenses;

Living expenses such as room and board; and

An allowance for costs expected to be incurred for dependent care for a student with dependents.⁷

The Texas State Board of Public Accountability (TSBPA) Fifth-Year Accounting Student Scholarship was one that I had to be concerned about in claiming the education credit, but again I did find this line on the TSBPA website that describes the uses for the award:

The award may be used at a participating college or university in Texas that is recognized by the Board. The award may be used for tuition, fees, books, supplies, and living expenses incurred by the student in connection with the student's fifth year of an accounting program.⁸

Document

Just as you would document that amounts were paid, or that a scholarship was used for qualified expenses, you should document your ability to treat scholarships as taxable income. Keep some official source document that says the scholarship may be used for other than qualified expenses, i.e. room and board. Official letters from the institution or printouts from official web pages would be some examples.

Coordinating with other benefits

Just as important as understanding the elective nature of traditional scholarships, federal grants, and AOTC qualified expenses, practitioners should be aware how they potentially interact with educational costs such as room and board or computer technology. Whenever possible, practitioners should look for the best combination of benefits, and work to coordinate them. This is particularly true if other sources are involved.

⁶ <http://www.utt Tyler.edu/scholarships/faq.php>, Accessed 3/25/2014.

⁷ <http://federalstudentaid.ed.gov/opportunity/questions.html>, Accessed 3/25/2014.

⁸ <http://www.tsbpa.state.tx.us/scholarship/awards-uses-for-the-award.html>, Accessed 3/25/2014.

Other sources of financial aid include Section 529, Coverdell savings accounts, and IRAs. Though not specifically an educational account, amounts in an IRA can be withdrawn and used for educational purposes without penalty. If you must choose between a Section 529 and an IRA, an IRA is the more versatile. One advantage of a 529 is that it can be used for high school, and for room and board. Contributions to a 529 or Coverdell, however, are locked in and can only be used for educational expenses.

Section 529 & Coverdell

In both Section 529 plans and Coverdell accounts contributions are not deductible but distributions are tax free if used for qualifying educational expenses. Section 529 QTP plans and Coverdell ESAs can be included in the calculation of elective scholarships. This is partly due to the terms in Section 529(e)(3)(B)(i) that allow room and board expenses for students attending at least half-time. Thus, even though housing costs paid from a Coverdell can be tax-free; those amounts do not offset qualified expenses includable for the purpose of education credits. Publication 970 also confirms this by describing how to coordinate with other aid to maximize education credits. The inclusion of an amount from these plans in income may be subject to a 10% penalty. Distributions, however, are not subject to a penalty provided the student receives a qualified scholarship that is used for qualifying expenses. That would then expose only the earnings to inclusion in taxable income, much like elective scholarships; and taxability of earnings is essentially limited to a pro rata share of earnings.

Keep in mind that a qualified scholarship is that portion of a scholarship used to pay qualified education expenses. The exclusion based on receipt of a scholarship applies only to the extent the distribution is not more than the scholarship, allowance, or payment. Additionally, the penalty does not apply if the distribution is included in income only because the qualified education expenses were taken into account in determining the American opportunity or lifetime learning credit. Form 1099-Q issued to the beneficiary provides the amount of the distribution, basis, and earnings on which to calculate tax liability. Form 5329 is used to report any taxable earnings or penalty.

A primary strategy then would be to use amounts from tax-free aid (Section 529, Coverdell, etc.) to cover room and board, which qualify as tax-free under those code sections; and if needed, use other scholarships as income to increase qualified expenses for the purposes of the education credits.

Computers

Yet another bonus of Coverdell is that certain computer technology purchases are now added to the list of elementary and secondary expenses that can be paid for by a qualified tuition program. The definition of qualified expenses in Section 530(e)(3)(A)(iii) includes computer technology, equipment and Internet access if they are used by the beneficiary and family. Carefully note that the computer expense for family and beneficiary was a qualified higher education expense for 2009 or 2010 only, according to Section 529(e)(3)(A)(iii).

Otherwise, computer equipment is only qualified for purposes of the AOTC if it is required.

Q7. Does an expenditure for a computer qualify for the American opportunity tax credit?

A. Whether an expenditure for a computer qualifies for the credit depends on the facts. An expenditure

for a computer would qualify for the credit if the computer is needed as a condition of enrollment or attendance at the educational institution.⁹

One characteristic of the Coverdell ESA is that there is a \$2,000 annual contribution limit, but distributions can also be used for elementary and secondary education expenses. Also, contributions to an account cannot be made after the beneficiary is age 18, and amounts must be distributed by the time the beneficiary is age 30. It is possible, though, to convert the trust to a new account or beneficiary.

IRAs

Traditional and Roth IRAs are treated similar to Section 529 and Coverdell savings accounts in relation to taxability of earnings and penalties if distributed and used for non-qualified educational expenses. However these IRAs have the added benefit of qualifying for the current Retirement Savings Credit when contributions are made, and do not require distributions when the beneficiary is a certain age. A Coverdell ESA is designed for saving for a beneficiary under age 18 so you can't use it to save for your own education. An IRA, however, can be treated like a Coverdell for any family member. Like the Coverdell, qualified expenses for the IRA include room and board for students that are at least half-time.

Planning

Typically, school years span five taxable years, with the student only going to school one semester in each of the first and last years, but the credit can only be claimed for four years. If the student has limited expenses in some semesters she may wish to wait until years where qualifying expenses are greater, or a final semester when she has taxable income where she can take advantage of the nonrefundable portion of the AOTC.

Another method to accelerate qualifying expenses is to make allowable prepayments. To maximize the potential benefits it may be possible due to Regulation 1.25A-5(e)(2) to pay for the final semester in the prior year. Prepayments must apply to expenses incurred in the first three months of the subsequent year. You do not have to pay all of the tuition, and you could purchase some of the books in advance.

It is also possible that the AOTC can be used to pay for the first two semester of graduate school. If a student graduates in May and then attends graduate school through the end of the year (summer and fall), all expenses for the year qualify for the AOTC. Form 8863 instructions are correct in indicating that the student cannot have earned a degree before the **start of the tax year**. Comments added to the final Treas. Reg. 1.25A-3(d)(2) in TD 9034 clarify that qualified expenses paid during the entire taxable year may be included in calculating the credit even if the student had completed their (then) first two years of undergraduate study during the year.

Understanding the benefits to graduate students can be important since other benefits, such as the Pell grant, go away at the same time tuition costs increase.

With the current law scheduled to expire in 2017, and no surety that it will be extended, few years remain to allow for planning how and when to use education credits.

⁹ <http://www.irs.gov/uac/American-Opportunity-Tax-Credit:-Questions-and-Answers>, Accessed 3/25/2014.

Side Effects and Concerns

The reporting for Education Credits could affect a number of other areas, so a careful eye is essential. These are just a few possible side effects or concerns.

AGI

By including scholarships in income AGI increases and tax may be owed on the scholarship amounts. The first \$2,000 of expenses generates a 100% tax credit, but the second \$2,000 only generates a 25% tax credit. If the marginal tax rate is above 25%, then it may be better to only include \$2,000 of elective scholarships in income. The increase in AGI could also initiate phase-outs or subject the taxpayer to AMT.

AOTC Phase-out:

AOTC is subject to a phase-out. The phase-out is essentially based on percentage of income between lower and upper phase-out limits. Thus, \$1000 over (based on \$10,000 range) would reduce your credit by 10%.

If you happen to be put into the phase-out range by including scholarships and grants in income, re-calculate the credit omitting some or all of the scholarships to determine the most advantageous treatment. Generally, it will be most advantageous to include the first \$2000 of expenses regardless of including scholarships in income. Above the first \$2000, the net benefit will largely depend on your marginal tax rate and deductions.

Earned Income

Scholarship income is excluded from earned income in the calculation of the earned income credit, so be sure to report and treat it that way. Include SCH and the amount to the left of line 7 on 1040. If you forget to add the SCH note, the IRS may "correct" the return and send the taxpayer an additional earned income credit which he doesn't deserve and may have to repay. Only amounts you receive for teaching, research, or other services would be considered earned income. Those amounts are not tax-free scholarships although they can be used to pay education expenses qualifying for education credits.

Support

Scholarships as support should not be a concern with current laws. If scholarships are used for qualified education expenses, they will not be considered support in determining dependency. If the student includes scholarships in income to maximize and it is considered support, it would be irrelevant since the education credit attaches to the exemption.

Educational Assistance

The amount that can be used to qualify for the AOTC education credit that are from an educational assistance program will depend on whether it is an educational assistance program under section 127(b).

Additional research may be necessary.

1098-T

Although the 1098-T may not be accurate or required to claim an education credit, the IRS may look at their 1098-T records to determine if a student was attending a college or university. Colleges and universities are not

required to submit or provide a 1098-T to their students in many cases. If one is not on file, you could receive a Form 886-H-AOC requesting alternate proof of attendance.

Education Credit Fraud

The benefits associated with education credits has recently been a target for tax fraud. At one point the IRS was examining returns with education credits more closely. However, the fraud has reportedly not been related to options made available in Regulation 1.25A-5. Instead, the cases that made their way to Tax Court had more to do with the plain language of basic qualifications such as age requirements, dependency exemptions, actual expenses¹⁰, prepayments¹¹, and phase-outs.

In 2013, many of the problems associated with education credits were due to forms not being completed properly, either through preparer negligence or software error.

The only case I found that concerned Treas. Reg. 1.25A-5 was a discussion of the change in a Louisiana program (TOPS) previously mentioned. The fact that there are so few cases that deal with the elective nature of scholarship income suggests that these regulations may be underutilized.

The reallocation of Pell grants to income to maximize the tax credit was most recently summarized in a Fact Sheet¹² distributed by the Treasury Department. Unfortunately the sample calculations are incorrect since the bulletin incorrectly assumes that scholarships will increase earned income and thus EITC.

Amending Prior Year Returns

When practitioners see clients they often like to see the prior year's return(s). That helps them to know what kind of credits and deductions they have taken in the past. A bright preparer will also reverse that logic. If he discovers that the taxpayer has credits or deductions this year that were not reported on the prior year's return he can question the taxpayer about whether he qualified for credits and deductions for the prior year, and then amend those returns. At that time, they may want to review the other two prior returns as well.

Many taxpayers may be left in the dark because institutions are not required to prepare 1098-Ts when all expenses are paid for by scholarships and grants. Practitioners should question any taxpayer in school, or with children in school about the nature of their educational expenses.

If taking advantage of Regulation 1.25A-5 in maximizing education credits is a new revelation, amending prior year returns can multiply the benefit by a factor of four and potentially earn \$10,000 in education credits. The net amount will be less if scholarships are included in income, since only 40% of the credit is refundable. When filing a return in the spring semester of the student's senior year a taxpayer (student or parent) can amend returns for his freshman, sophomore, and junior year at the same time he files his senior year return. As previously mentioned, there may be years that are more beneficial than others, so planning is still a factor.

¹⁰ Adams v Comm'r, Tax Court Summary Opinion 2013-57.

¹¹ Jayesh B. v Comm'r, Tax Court Summary Opinion 2006-40.

¹² <http://www.treasury.gov/connect/blog/Documents/Pell%20AOTC%204%20pager.pdf>. Accessed 11/6/2014.

Amending returns could also be used to change prior year decisions related to education credits. If you didn't maximize the credit in one year and you can in a following year, you may want to amend. You need to be careful, however, since you could be subject to late payment penalties if you have to repay for the credit.

Conclusion

When clients mention educational expenses and then dismiss them because everything was covered by scholarships and other financial aid, ask to take a look and explain that they may be able to claim education credits of up to \$2,500, especially if some of the expenses were paid with student loans or Pell grants.

Even better, use the tax questionnaire to let clients know of the potential credit, even if they do not receive a 1098T or are not out of pocket for any of the expenses. By understanding the regulations and the ability to treat scholarships as income, you can pleasantly surprise your clients. All that is needed is a little pre-season preparation, organization of client educational records, and a worksheet that calculates qualifying expenses used for the credit. Then see if that can be duplicated with prior year returns.