Introduction

This lesson covers tax credits available to help the taxpayer offset the costs of higher education by reducing the amount of income tax. This lesson suggests probing questions you can ask based on the intake and interview sheet, the Volunteer Resource Guide, Education Benefits tab, and on the rules for claiming education credits.

During the interview, ask taxpayers if they are aware of the education credits, and give a brief description. Next, gather information to determine if any credits can be claimed.

Objectives

At the end of this lesson, using your resource materials, you will be able to:

- Determine who qualifies for an education credit
- Determine which credit the taxpayer can claim

What are education credits?

Education credits are amounts that will reduce the amount of tax due. The amount is based on qualified education expenses that the taxpayer paid during the tax year.

There are two different education credits: the American opportunity credit and the lifetime learning credit. The American opportunity credit allows 40% of the credit to be refundable. There are general rules that apply to these credits, as well as specific rules for each credit.

For an overview of the various education tax benefits, review the Volunteer Resource Guide, Education Benefits tab, Highlights of Education Tax Benefits.

Who can take an education credit?

Taxpayers can take education credits for themselves, their spouse, and/or dependents (claimed on the tax return) who were enrolled at or attended an eligible postsecondary educational institution during the tax year.

What basic requirements must the taxpayer meet?

To claim an education credit, verify that the following are true for the taxpayers:

- They cannot be claimed as a dependent on someone else’s tax return
- They are not filing as Married Filing Separately
- Their adjusted gross income (AGI) is below the limitations for their filing status
- They were nonresident aliens for any part of the tax year, or if they were, they elected to be treated as resident aliens

Refer to the Volunteer Resource Guide, Education Benefits tab, for the Education Credits Tips.
How do I handle dependents?

The taxpayer must claim the student as a dependent to receive the credit for the student’s qualified expenses. Refer to the Education Credits Tips in the Volunteer Resource Guide, Education Benefits tab, demonstrated by the following example:

example

Carol Marshall has a grandson named Gary. He is claimed as a dependent on his parent's joint return. Carol paid Gary's tuition directly to the university. For purposes of claiming an education credit, Gary is treated as receiving the money as a gift and paying for the qualified tuition and related expenses. Since his parents are claiming him on their return, they may be able to use the expenses to claim an education credit. Alternatively, if he is claiming himself on his return, he might be able to claim the expenses as if he paid them to the school.

What is an eligible institution?

An eligible institution is any college, university, vocational school, or other postsecondary educational institution eligible to participate in a student aid program administered by the U.S. Department of Education. The school should be able to tell the student if it is an eligible education institution. A searchable database of all accredited schools is available at http://ope.ed.gov/accreditation/.

What are qualifying expenses?

Qualified education expenses are tuition and certain related expenses required for enrollment or attendance at an eligible educational institution. However, for the American opportunity credit, the definition for “certain related expenses” is different from the lifetime learning credit. This will be discussed later in the lesson.

example

When Janice enrolled for her freshman year of college, she had to pay a separate student activity fee in addition to her tuition. This activity fee is required of all students and is used solely to fund on-campus organizations and activities run by students, such as the student newspaper and the student government. No portion of the fee covers personal expenses. Although labeled as a student activity fee, the fee is required for Janice’s college enrollment and attendance; therefore, it is a qualified expense.

Ask to see documentation, such as receipts or Form 1098-T, Tuition Statement, issued by the school. Identify the expenses that qualify for education credits.

Which expenses do not qualify?

Do not include expenses such as:

- Room and board, insurance, medical expenses (including student health fees), transportation costs, or other similar personal, living, or family expenses
- Any course of instruction or other education involving sports, games, or hobbies, unless the course is part of the student’s degree program or (for the lifetime learning credit) helps the student to acquire or improve job skills
Are any amounts excluded from qualified expenses?

Certain tax-free funds used to pay tuition cannot be used to figure the credit. Once you have identified each person claiming a credit and their qualified expenses, ask if the student received any of these untaxed educational benefits during the year:

- Pell grants.
- Employer-provided educational assistance.
- Veterans’ educational assistance.
- Tax-free portions of scholarships and fellowships.
- Any other nontaxable payments received as educational assistance (other than gifts or inheritances). For example, distributions from a 529 plan reported on Form 1099-Q, Payments From Qualified Education Programs (Under Sections 529 and 530).
- Refunds of the year’s qualified expenses paid on behalf of a student (e.g., the student dropped a class and received a refund of tuition).

Subtract the tax-free educational assistance, refunds, and benefits from the student’s qualified expenses. These tax-free benefits are listed in the Education Credits Interview Tips in the Volunteer Resource Guide, Education Benefits tab. For additional information, see Publication 970, examples 1 and 2 in the American Opportunity Credit chapter, heading Adjustments to Qualified Education Expenses.

Most students will receive Form 1098-T from the educational institution. The form should show the amounts the student paid for tuition and related expenses, the amounts of scholarships and grants received, and whether the student was at least a half-time student or a graduate student. Verify with the taxpayer that the amount in Form 1098-T, box 1 or 2, is actually the amount paid in the current tax year for qualified expenses.

Example

Joan Smith received Form 1098-T from the college she attends. It shows her tuition was $9,500 and that she received a $1,500 scholarship. She had no other scholarships or nontaxable payments. Her maximum qualifying expenses for the education credit would be $8,000 ($9,500 - $1,500).

Example

Brandon had $5,000 of qualified education expenses and $4,000 of room and board. He received a $5,000 Pell grant and took out a $2,750 student loan to pay these expenses. His parents paid the remaining $1,250. By its terms, the Pell grant may be used for any of these expenses. Brandon and his parents opted to use $4,000 of the Pell grant to cover room and board, and the other $1,000 to cover the qualified education expenses. After reducing qualified education expenses by the tax-free grant, Brandon has $4,000 ($5,000 - $1,000) of adjusted qualified education expenses available to figure the education credit. Brandon used the student loan of $2,750 and his parents’ payment of $1,250 to cover the qualified education expenses.
What about payments for the next academic year?

The taxpayers can claim payments prepaid for the academic period that begins in the first three months of the next calendar year. Refer to the Volunteer Resource Guide, Education Benefits tab, Education Credits.

**example**

Thomas pays $1,500 in December for qualified tuition for the winter semester that begins in January. He can use the $1,500 paid in December to compute his credit for the current tax year. He cannot count it again next tax year.

What rules apply to each credit?

How do the credits compare?

There are several differences between the two credits.

The American opportunity credit:

- Can be claimed based on the same student’s expenses for no more than four tax years, including any years the Hope credit was claimed
- Available only if the student has not completed the first four years of post-secondary education before the beginning of the tax year
- Qualified tuition and related expenses include expenses for course materials – books, supplies, and equipment needed for a course of study, whether or not the materials are purchased from the educational institution as a condition of enrollment or attendance
- Generally, 40% of the credit is a refundable credit, which means taxpayers can receive up to $1,000 even if they owe no taxes

Lifetime learning credit:

- There is no limit on the number of years the lifetime learning credit can be claimed for each student
- Available for all years of post-secondary education and for courses to acquire or improve job skills
- Course-related books, supplies, fees, and equipment are included in qualified education expenses only if they must be paid to the institution as a condition of enrollment or attendance
- No portion of the credit is refundable

**American Opportunity Tax Credit**

Taxpayers can take the American opportunity credit for a student if they can answer all of these questions as indicated below:

- As of the beginning of the tax year, was the student still in the first four years (generally, the freshman, sophomore, junior, and senior years) of postsecondary study? Yes
- Was the student enrolled in a program that leads to a degree, certificate, or other credential? Yes
- Was the student taking at least one-half the normal full-time workload for the course of study, for at least one academic period beginning in the current tax year? Yes
- Has the student been convicted of a felony for possessing or distributing a controlled substance? No

*Tip* If the student does not meet all of the conditions for the American opportunity credit, the taxpayer may be able to take other education benefits for part or all of the student's qualified expenses.
The American opportunity credit can be up to $2,500 per eligible student, depending on the amount of eligible expenses and the amount of tax on the return. The credit is 100% of the first $2,000 and 25% of the second $2,000 of eligible expenses per student, up to the amount of tax. Forty percent of the American opportunity credit is a refundable credit, which means the taxpayer can receive up to $1,000 even if no taxes are owed. Taxpayers under age 24 cannot claim the refundable portion of the credit if certain conditions are met. Refer to Volunteer Resource Guide, Education Benefits tab, Student Under Age 24 Claiming American Opportunity Credit, for details.

The American opportunity credit is available for the first four years of college per eligible student (generally, freshman through senior years of college).

Example

Mindy’s brother, Jim, started college in 2008. He claimed the Hope credit for his first year of college (2008). In 2009, Jim attended college and took less than half the normal requirements. Since the American opportunity expanded the education credit for the first four years of postsecondary education, he claimed the American opportunity tax credit for tax years 2010 through 2012 when he was considered a full-time student.

The lifetime learning credit can be taken if the taxpayer and the expenses meet the requirements described under “What basic requirements must the taxpayer meet?” Refer to the Volunteer Resource Guide, Education Benefits tab, for the Education Credits Tips. The student need not be enrolled half-time or in a degree program, and a felony drug conviction does not disqualify the student.

The lifetime learning credit can be up to $2,000 per tax return, depending on the amount of eligible expenses and the amount of tax on the return. The credit is 20% of the first $10,000 of eligible expenses paid for all students, up to the amount of tax on the return.

Example

Toby had receipts for books and supplies his first year at college. He spent $1,291 for required books, lab supplies, and rock-hunting equipment he needed for his introductory chemistry and geology courses. The school has no policy requiring that these books and equipment be purchased from the college in order to enroll. These are qualified expenses for the American opportunity credit.

Example

Jill attends Wanda’s School of Beauty, an eligible institution. She pays $4,400 for the course of study, which includes tuition, equipment, and books required for the course. The school requires that students pay for the books and equipment when registering for the course. The entire $4,400 would be an eligible educational expense.

Example

Jack attends a culinary school on Saturdays. He pays $4,400 for the course of study and qualifies for the Lifetime Learning credit. The school provides a list of equipment that he needs to bring to class. The $4,400 is an eligible educational expense, but the cost of the equipment and supplies is not.
EXERCISES

Use the Volunteer Resource Guide, Education Benefits tab, and Publication 17, Comparison of Education Credits, to answer the following questions. Answers are at the end of the lesson summary.

Question 1: Bob was a full-time student and a fifth-year senior. He has only claimed the American opportunity and Hope credit in three earlier years. Does he qualify for the American opportunity credit?
□ Yes □ No

Question 2: Janice works full time and takes one course a month at night school. Some of the courses are not for credit, but they are meant to advance her career. Which credit is appropriate for her?
□ American opportunity □ Lifetime

Question 3: Clark is an older student who has gone back to college half time after serving 18 months in prison for felony drug possession. Which credit is appropriate for him?
□ American opportunity □ Lifetime

Can a taxpayer take multiple education benefits?

Education expenses can be taken in any of several areas on the tax return. They can be used toward one of these credits, as a work-related deduction on Schedule A, as a business expense on Schedule C or C-EZ, or to reduce the taxable portion of scholarships, fellowships, grants and distributions from education savings accounts. The definition of a qualifying expense varies among these different benefits, but in general, each expense can be used only once. For example, do not:

- Figure the education credits based on expenses that have already been taken on Schedule A or Schedules C and C-EZ
- Take both an American opportunity credit and a lifetime learning credit for the same student in the same year

A taxpayer who has taken an early distribution from an IRA may take an exception to the 10% additional tax based on expenses that are also used toward another education benefit.

Tax Software Hint: To review information related to software entries, go to the Volunteer Resource Guide, Education Benefits tab.

How do I determine the amount of the credit?

Here are the general steps in figuring the amount of education credits:

1. Review the list of qualifying students and expenses and decide if the American opportunity credit or lifetime learning credit is more suitable (see the requirements discussed earlier).

2. Form 8863, Part III, page 2, requests information about the student, the student’s eligibility for the credit, and the educational institution(s). Taxpayers must complete Part III for each eligible student for whom they are claiming an education credit before completing Parts I and II.
3. Enter each student's qualified expenses. Be sure that these:
   - Include only qualified expenses
   - Are reduced by untaxed benefits
   - Do not exceed the limit for the credit

4. Find the totals for each section and apply the limits, then transfer the amounts to Parts I and II to determine the refundable and nonrefundable credits. Apply the income test and do the calculations. (Tax software does this step for you.)

**Tax Software Hint:** When entering qualified expenses, the software allows you to choose which benefit. At this point, you can make changes to determine the most beneficial education benefit to claim for the taxpayer.

If you find taxpayers claimed an education credit in a prior year and they were refunded part or all of the expenses they used to claim the American opportunity or lifetime learning credit, they may have to repay (recapture) all or part of the credit. Information can be found in Publication 970, but this is beyond the scope of the VITA/TCE programs. Advise the taxpayer to consult a professional tax preparer.

**Taxpayer Interview and Tax Law Application**

Here is how our volunteer helped taxpayer, Barbara Smith, determine which education credits applied to her family.

**SAMPLE INTERVIEW**

<table>
<thead>
<tr>
<th>VOLUNTEER SAYS...</th>
<th>BARBARA RESPONDS...</th>
</tr>
</thead>
<tbody>
<tr>
<td>Barbara, are you familiar with education credits?</td>
<td>They have something to do with tuition.</td>
</tr>
<tr>
<td>Yes, they apply to certain expenses for postsecondary education. Did anyone in the family attend college or vocational school during the tax year?</td>
<td>My daughter, Carla, is a freshman, going to college full time, and I am taking classes at City College.</td>
</tr>
<tr>
<td>There are two kinds of credits – here's a chart comparing the two education credits. [Explains the differences.]</td>
<td>Looks like American opportunity for Carla and lifetime for me!</td>
</tr>
<tr>
<td>I think you're right. You both meet the basic requirements, since you are both on the return and meet the income limits. Did you bring any receipts for education expenses?</td>
<td>Yes, these are for Carla's tuition, fees, and books for the tax year. These are for extracurricular field hockey.</td>
</tr>
<tr>
<td>The books will qualify but her field hockey costs will not. Did she receive any tax-free benefits from an employer, a scholarship, Pell grant, anything like that?</td>
<td>Only $5,000 from her grandfather.</td>
</tr>
<tr>
<td>We don't need to count the gift. The American opportunity credit is available for a student's first four years of college, so that might be the best for you to claim. Now let's look at your expenses. Are these to improve your job skills?</td>
<td>All I have are tuition and fees for two classes in accounting, spring and fall semesters.</td>
</tr>
<tr>
<td></td>
<td>Yes, but my boss doesn't reimburse me.</td>
</tr>
</tbody>
</table>
Which education benefit is better for the taxpayer?

Taxpayers have several options for using education expenses to reduce taxes. They are:

- American opportunity credit or lifetime learning credit
- Itemized deduction on Schedule A (employee-related expenses only)
- Business expenses on Schedules C and C-EZ

Generally, taxpayers will benefit the most from claiming the education credits. However, you should compute any of the other benefits for which taxpayers are eligible to determine which gives them the lowest tax. Do not claim multiple benefits for the same education expense; use the benefit most advantageous to the taxpayer.

Refer to the Volunteer Resource Guide, Education Benefits tab, References – Highlights of Education Tax Benefits for a comparison chart of some of the tax benefits for education.

How can I avoid common errors?

If you complete Form 8863, make sure that you have entered the names, SSNs, and education expense amounts correctly. Check that you have not claimed more than one tax benefit for the same taxpayer or taken a credit or deduction for expenses paid with a tax-free benefit like a scholarship.

On the intake and interview sheet, make sure that the appropriate box is checked to indicate that the taxpayer had education expenses. Note anything unusual that the quality reviewer may need to know when reviewing this part of the tax return. For example, you could note if some expenses were paid with a nontaxable scholarship.

Summary

You are now ready to help taxpayers determine which education tax benefits are best for them. When you get to this section of the return, always check the intake and interview sheet and ask probing questions based on the taxpayer’s information and on the rules for claiming education credits.

There are two education credits that may reduce a taxpayer’s tax:

- American opportunity credit
- Lifetime learning credit
Education expenses can be applied to those credits, deducted on Schedules C and C-EZ, itemized on Schedule A, or used to reduce taxable portion of scholarships, grants, fellowships and distributions from education savings accounts. Choose the method that will give the taxpayer the lowest tax. The American opportunity credit can be claimed for students in their first four years of college and may be more beneficial than the lifetime learning credit. Remember, 40% of the American opportunity credit is a refundable credit, which means taxpayers can receive up to $1,000 even if they have no tax liability.

One of your roles as a volunteer is to help taxpayers maximize the benefits that they are entitled to under the tax law. Stay alert to ways they can use their education expenses to lower their tax.

**What situations are out of scope for the VITA/TCE programs?**

The following is out of scope for this lesson. While this list may not be all inclusive, it is provided for your awareness only.

- Taxpayers who must repay (recapture) part or all of an education credit claimed in a prior year.

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**TAX LAW APPLICATION USING THE WORKBOOK**

To gain a better understanding of the tax law, complete the comprehensive problem or practice exercise(s) for your course of study in Publication 4491-W.

For practice using the tax preparation software, complete the scenarios using the Practice Lab on L&LT.

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**EXERCISE ANSWERS**

**Question 1:** Yes. Bob qualifies for the American opportunity credit because he only claimed the credit in three previous tax years.

**Question 2:** Lifetime

**Question 3:** Lifetime
Notes