Maximizing Education Tax Credits

As students head back to college, they and their families face the increasingly daunting task of paying tuition bills. The tax law does provide some relief. For example, the American Opportunity credit and the Lifetime Learning credit can reduce the after-tax cost of college expenses.

Tax professionals also have a role here. They can help clients obtain maximum benefit from these incentives.

Test Your Credit Score. For 2015, eligible taxpayers can claim an American Opportunity credit of 100% of the first $2,000 of qualifying expenses and 25% of the next $2,000 of qualifying expenses for each of the first four years of a student's higher education—a maximum credit of $2,500 per student per year. The Lifetime Learning credit is available for 20% of up to $10,000 of qualifying higher expenses, up to a maximum credit of $2,000 per year. Unlike the American Opportunity credit, the Lifetime Learning credit is calculated on a per-family (i.e., per tax return) basis, not on a per-student basis. Moreover, both the American Opportunity and Lifetime Learning credits cannot be claimed for the same student in a tax year.

The credits are phased out for higher income taxpayers. For 2015, the Lifetime Learning credit is phased out for joint filers with modified adjusted gross income (MAGI) between $110,000 and $130,000, and for other filers with MAGI between $55,000 and $65,000. The phaseout range for the American Opportunity credit is $160,000 to $180,000 for joint filers and $80,000 to $90,000 for other filers. On the other hand, up to 40% of the American Opportunity credit is refundable for taxpayers with little or no tax liability to offset.

Timing Counts. The credits are generally allowed only for payments of qualifying expenses for an academic period beginning in the same tax year the payments are made. (An academic period is a quarter, semester, trimester or other period of study, such as a summer school session, as reasonably determined by the eligible educational institution.)

However, there is an exception to the general rule. If qualified tuition and related expenses are paid during one tax year for an academic period that begins during the first three months of the next tax year (i.e., in January, February, or March of the next tax year for calendar year taxpayers), an education tax credit is allowed, not in the year the academic period begins, but instead, in the year the expenses are paid [IRC Sec. 25A(g)(4)].

> **Example.** Zelon College charges Charlie Abbott $2,000 in qualifying expenses to attend classes during the 2016 spring semester, which begins in February 2016. If Abbott pays the college in December 2015, he can claim an education tax credit in 2015 for the 2016 spring semester expenses. On the other hand, if Abbott makes the $2,000 payment in January 2016, the general rule applies and the payment is creditable in 2016.

Borrowing Counts. An education credit may be claimed for qualified tuition and related expenses paid with the proceeds of a loan. The credit can be claimed only in the year payment is made with the loan proceeds, not in the year the debt is incurred or the year it's repaid.

Loan proceeds disbursed directly to a college will be treated as "paid" on the date the college credits the proceeds to the student's account. For example, in the case of any loan issued or guaranteed as part of a federal student loan program under Title IV of the Higher Education Act of 1965 (e.g., Pell Grant), loan proceeds will be treated as paid on the date of disbursement to the college.

While a client has little control over the date the college credits the account, the client may want to ask the college precisely when date that is. This can make a difference as to which year the credit can be claimed. IRS regulations provide that if a taxpayer does not know the date the college credits the student's account, the taxpayer must treat the qualifying expenses as paid on the last date for payment prescribed by the college [Reg. 1.25A-5(e)(5)]. This might force a delay in claiming the credit.

Family Counts. If a client claims a student as a dependent, the client can claim an education credit for the student's expenses. Moreover, any expenses paid or deemed paid by the student are treated as paid by the client when figuring the credit. Thus, for example, a client can claim an education credit for college expenses paid by a dependent student with earnings from a summer job or from college loans in the student's name.

If a third party (say, a grandparent or a noncustodial parent) makes payment directly to an eligible educational institution for a student's education expenses, the student is treated as receiving the payment from the third party and, in, turn paying the expenses to the institution. Thus, if the student is claimed as dependent by your client, the payments can be taken into account in calculating your client's credit.

On the flip side, if your client does not claim the student as a dependent, the student can claim an education credit on his or her return. That's true even if your client is eligible to claim the student as a dependent. Moreover, payments made by the client for the student's expenses can be counted towards the credit on the student's return.