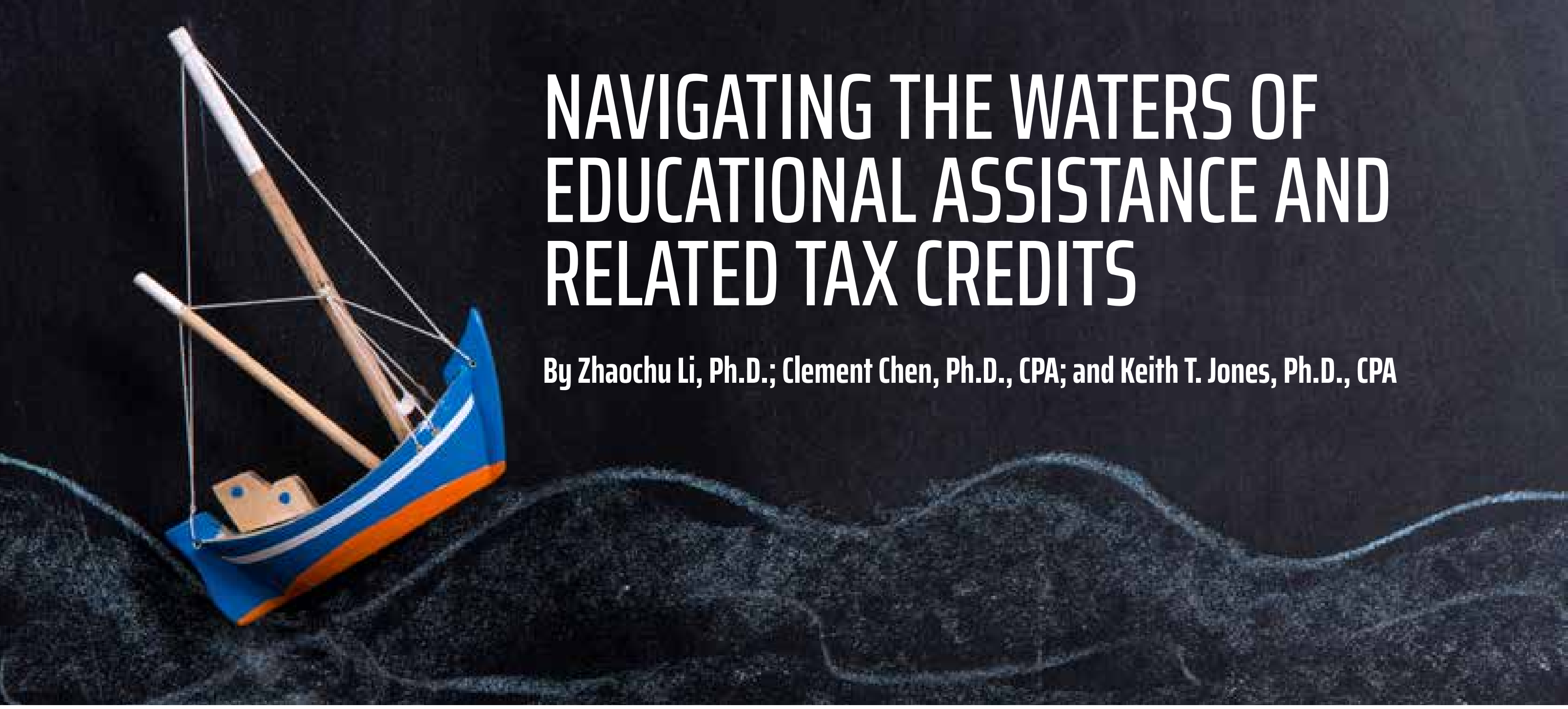

NAVIGATING THE WATERS OF EDUCATIONAL ASSISTANCE AND RELATED TAX CREDITS

By Zhaochu Li, Ph.D.; Clement Chen, Ph.D., CPA; and Keith T. Jones, Ph.D., CPA

Taxpayers often receive educational assistance to finance their postsecondary studies. Examples of educational assistance include scholarships, grants and fellowships. Educational assistance is tax-exempt if used to pay for expenses, such as tuition and required fees.

At the same time, taxpayers are eligible to take education credits that reduce their overall tax liability. Two available education credits are the American opportunity credit (AOC) and the lifetime learning credit (LLC). Although it seems counter-intuitive to include tax-exempt educational assistance in income, doing so can potentially increase a taxpayer's eligible education credit and reduce a taxpayer's overall tax liability.

This article provides a detailed explanation as to whether and how much educational assistance a taxpayer should include in taxable income to have the lowest tax liability. Unfortunately, most taxpayers are not aware of this strategy and tax-filing software generally does not provide the proper guidance. Therefore, CPAs and tax advisers may be able to help their clients save significant taxes using the strategy from this article.

CPAs and tax advisers may be able to help their clients save significantly by using this tax-saving strategy.

Pitfalls When Claiming Both Tax-Exempt Educational Assistance and Education Credits

When a taxpayer excludes educational assistance from income, the Internal Revenue Service (IRS) assumes that the taxpayer uses the assistance to pay for qualified education expenses. The definition of qualified education expenses differs among types of educational assistance and tax credits, but always includes tuition and required fees.

For example, scholarships are the most common type of educational assistance and qualified education expenses for scholarships include tuition, required fees and course-related expenses, such as books, supplies and equipment. For the AOC, qualified education expenses are the same as for scholarships; however, for the LLC, course-related expenses must be paid directly to a taxpayer's educational institution to be considered as qualified education expenses.

Issues can arise when a taxpayer receives educational assistance and claims an education credit at the same time. If a taxpayer chooses to exclude all or part of the educational assistance from taxable income, he/she must use adjusted qualified education expense (AQEE) to calculate education tax credits. The IRS defines AQEE as qualified education expenses less any tax-exempt educational assistance (IRS 2017).

As a result, the available tax credit may be smaller, due to the reduced AQEE. However, if a taxpayer includes some

educational assistance in income, he/she could have a larger AQEE and may be eligible for a larger tax credit.

Scholarship Example. Brian is a sophomore in college and pays tuition of $4,000, which is his only education expense. Brian's college awards him a scholarship of $3,000 and credits it directly to his school account. If Brian chooses to exclude the entire scholarship from his income, his tax-exempt educational assistance is $3,000. His AQEE for the AOC is thus $1,000 (4,000 – 3,000), allowing him to claim $1,000 of the credit. However, if Brian chooses to exclude only $2,000 of the scholarship from his income, his tax-exempt educational assistance is $2,000.

His AQEE for the AOC becomes $2,000 (4,000 – 2,000) and he could claim $2,000 of the credit. The reason that Brian may want to include more scholarship in his income is explained below.

EXHIBIT 1: FIGURING SCHOLARSHIP INCLUSIONS FOR THE AMERICAN OPPORTUNITY CREDIT BASED ON MARGINAL TAX RATE (MTR) AND ADJUSTED QUALIFIED EDUCATION EXPENSE (AQEE)

Step 1. Exclude the entire scholarship and find a taxpayer's taxable income. Use the taxable income to determine the MTR.

Step 2. Subtract the entire scholarship from the sum of tuition and required fees and course-related expenses to determine the AQEE.

Step 3. If AQEE ≥ $4,000, do not include any scholarship in income. The taxpayer can already claim the maximum credit of $2,500.

If $2,000 ≤ AQEE < $4,000, do not include any scholarship in income yet and go to Step 4.

If AQEE < $2,000, include as much scholarship as possible in income until AQEE increases to $2,000, then go to Step 4.

Step 4. Use the taxpayer's MTR from Step 1.

If MTR ≥ 25%, do not include any more scholarship in income. Calculate the credit using the sum of AQEE from Step 2 and any scholarship inclusion from Step 3.

If MTR < 25%, include as much scholarship as possible in income until either AQEE increases to $4,000 or MTR increases to 25%. Calculate the credit using the sum of AQEE from Step 2 and all scholarship inclusions from Step 3 and 4 (if any).

Why Include Tax-Exempt Educational Assistance in Income?

There are two simultaneous effects when including any educational assistance in taxable income. On the one hand, the inclusion results in an additional tax liability, which is the product of the included educational assistance and the taxpayer's marginal tax rate (MTR). On the other hand, the inclusion means that a taxpayer could potentially have a higher AQEE for education credits and thus claim a larger AOC or LLC.

Whether the increase in tax liability is more than the increase in an education credit depends on a taxpayer's MTR and AQEE and whether the taxpayer claims the AOC or the LLC. The following sections in this article explain whether to include scholarships in income to minimize taxes and how much to include. The same analysis applies to other types of educational assistance.

The American Opportunity Credit and Scholarship Inclusions

The AOC allows a maximum credit of $2,500 per student per year. The credit equals the first $2,000 of AQEE plus 25% of the next $2,000. AQEE over $4,000 does not generate additional credit. Exhibit 1 provides a step-by-step guide for including scholarships in income when claiming the AOC.

Table 1 includes examples for Exhibit 1. It compares four cases with different scholarship inclusions and tax savings. All cases assume that college student John pays $5,000 for tuition and required fees and receives a scholarship of $4,000. His MTR is 12% before including any scholarship in his income. If John excludes the entire scholarship from income, his AQEE for the AOC is $1,000 (5,000 – 4,000), based on which John can claim $1,000 of the AOC. Table 1 ignores other factors that could affect

TABLE 1:
SCHOLARSHIP INCLUSIONS AND THE AMERICAN OPPORTUNITY CREDIT BASED ON MTR = 12%

	Case 1	Case 2	Case 3	Case 4
Education expenses; scholarships	Tuition/fees: $5,000 Scholarship: $4,000			
Scholarship inclusion	$1,000	$2,000	$3,000	$4,000
Tax-exempt scholarship	3,000 (4,000 – 1,000)	2,000 (4,000 – 2,000)	1,000 (4,000 – 3,000)	0 (4,000 – 4,000)
Additional taxable income	1,000	2,000	3,000	4,000
Additional tax liability	120 (1,000 x 12%)	240 (2,000 x 12%)	360 (3,000 x 12%)	480 (4,000 x 12%)
AQEE before scholarship inclusion	1,000 (5,000 – 4,000)	1,000 (5,000 – 4,000)	1,000 (5,000 – 4,000)	1,000 (5,000 – 4,000)
AQEE after scholarship inclusion	2,000 (5,000 – 3,000)	3,000 (5,000 – 2,000)	4,000 (5,000 – 1,000)	5,000 (5,000 – 0)
Tax credit before scholarship inclusion	1,000	1,000	1,000	1,000
Tax credit after scholarship inclusion	2,000	2,250 (2,000 + ((1,000 x 25%))	2,500 (2,000 + ((2,000 x 25%))	2,500 (2,000 + ((2,000 x 25%))
Additional tax credit after scholarship inclusion	1,000 (2,000 – 1,000)	1,250 (2,250 – 1,000)	1,500 (2,500 – 1,000)	1,500 (2,500 – 1,000)
Tax Savings (additional credit – additional liability)	$880 (1,000 – 120)	$1,010 (1,250 – 240)	$1,140 (1,500 – 360)	$1,020 (1,500 – 480)

the decision for scholarship inclusion and assumes that John has sufficient tax liability to absorb the credit.

In Case 1, John includes $1,000 of the scholarship in his income and his AQEE increases to $2,000. His tax liability and tax credit increase by $120 and $1,000, respectively, resulting in a tax savings of $880. In Cases 2 and 3, John includes $2,000 and $3,000 of his scholarship in income and his tax savings become $1,010 and $1,140 respectively. The first three cases show that John's tax savings increase as he includes more scholarship in income.

However, in Case 3, John's AQEE after scholarship inclusion reaches $4,000, which is the maximum amount of expense a taxpayer can use to claim the AOC. According to Exhibit 1, John should stop including any more scholarship in his income, because doing so will increase his tax liability, but not his tax credit. As shown in Case 4, if John includes $1,000 more scholarship income than in Case 3, he will pay $120 more tax.

The Lifetime Learning Credit and Scholarship Inclusions

The LLC equals 20% of the first $10,000 of AQEE, for a maximum of $2,000 per year in an undergraduate or graduate program. In contrast to the AOC, the LLC is not limited to the first four years of postsecondary education. Qualified education expenses for the LLC include tuition and required fees, but do not include course-related expenses, such as books and supplies, unless they are paid directly to a taxpayer's educational institution. Exhibit 2 provides a step-by-step guide for including scholarships in taxable income when claiming the LLC.

Table 2 includes examples for Exhibit 2 by comparing four cases with different scholarship inclusions and tax savings. All cases assume that college student Kim pays $11,000 for tuition and fees and receives a scholarship of $4,000. Her MTR is 12% before any scholarship inclusion.

EXHIBIT 2:
FIGURING SCHOLARSHIP INCLUSIONS FOR THE LIFETIME LEARNING CREDIT BASED ON MARGINAL TAX RATE (MTR) AND ADJUSTED QUALIFIED EDUCATION EXPENSE (AQEE)

Step 1. Exclude the entire scholarship and find a taxpayer's taxable income. Use the taxable income to determine the taxpayer's MTR.

Step 2. Subtract the entire scholarship from the sum of tuition and required fees to determine the AQEE. If course-related expenses, such as books and supplies, are paid directly to the taxpayer's educational institution, add these expenses to the AQEE.

Step 3. If AQEE >= $10,000, do not include any scholarship in income. The taxpayer can already claim the maximum credit of $2,000.

If AQEE < $10,000, do not include any scholarship in income yet and go to Step 4.

Step 4. Use the taxpayer's MTR from Step 1.

If MTR ≥ 20%, do not include any scholarship in income. Calculate the credit using AQEE from Step 2.

If MTR < 20%, include as much scholarship as possible in income until either AQEE increases to $10,000 or MTR increases to 20%. Calculate the credit using the sum of AQEE from Step 2 and any scholarship inclusion from Step 4.

If Kim excludes the entire scholarship from taxable income, her AQEE for the LLC is $7,000 (11,000 – 4,000), based on which Kim can claim $1,400 (7,000 × 20%) of the LLC. Table 2 ignores other factors that could affect the decision for scholarship inclusion and assumes that Kim has sufficient tax liability to claim all of the LLC.

In Case 1, she includes $1,000 of the scholarship in her income and her AQEE becomes $8,000. Kim's tax liability and tax credit increase by $120 and $200 respectively, resulting in a net tax savings of $80. In Cases 2 and 3, Kim includes $2,000 and $3,000 of the scholarship in her income and her net tax savings become $160 and $240, respectively.

The first three cases show that Kim's net tax savings increases as she includes more scholarship in income. However, in Case 3, Kim's AQEE after scholarship inclusion reaches $10,000, which is the maximum amount of expenses a taxpayer can use to claim the LLC. Based on Exhibit 2, Kim should stop including any more scholarship in her income because doing so will increase her tax liability, but not her tax credit. As shown in Case 4, if Kim includes $1,000 more scholarship income than in Case 3, she will pay $120 more tax.

Include any educational assistance in income to minimize taxes. Therefore, it is important that CPAs and tax professionals inform their clients about implementing this tax-saving strategy.

Potential Tax Savings

Taxpayers generally prefer to exclude tax-exempt educational assistance from their income. However, including some tax-exempt educational assistance in income could potentially increase a taxpayer's education credit and reduce his/her overall tax.

Unfortunately, tax preparation software generally only asks users if they have any out-of-pocket education expense, but does not tell users whether they should include any educational assistance in income to minimize taxes. Therefore, it is important that CPAs and tax professionals inform their clients about implementing this tax-saving strategy.

First, tax advisers should alert their clients about potential pitfalls when claiming tax-exempt educational

TABLE 2:
SCHOLARSHIP INCLUSIONS AND THE LIFETIME LEARNING CREDIT BASED ON MTR = 12%

	Case 1	Case 2	Case 3	Case 4
Education expenses; scholarships	Tuition/fees: $11,000 Scholarship: $4,000			
Scholarship inclusion	$1,000	$2,000	$3,000	$4,000
Tax-exempt scholarship	3,000 (4,000 – 1,000)	2,000 (4,000 – 2,000)	1,000 (4,000 – 3,000)	0 (4,000 – 4,000)
Additional taxable income	1,000	2,000	3,000	4,000
Additional tax liability	120 (1,000 x 12%)	240 (2,000 x 12%)	360 (3,000 x 12%)	480 (4,000 x 12%)
AQEE before scholarship inclusion	7,000 (11,000 – 4,000)	7,000 (11,000 – 4,000)	7,000 (11,000 – 4,000)	7,000 (11,000 – 4,000)
AQEE after scholarship inclusion	8,000 (11,000 – 3,000)	9,000 (11,000 – 2,000)	10,000 (11,000 – 1,000)	11,000 (11,000 – 0)
Tax credit before scholarship inclusion	1,400 (7,000 x 20%)	1,400 (7,000 x 20%)	1,400 (7,000 x 20%)	1,400 (7,000 x 20%)
Tax credit after scholarship inclusion	1,600 (8,000 x 20%)	1,800 (9,000 x 20%)	2,000 (10,000 x 20%)	2,000 (10,000 x 20%)
Additional tax credit after scholarship inclusion	200 (1,600 – 1,400)	400 (1,800 – 1,400)	600 (2,000 – 1,400)	600 (2,000 – 1,400)
Tax Savings (additional credit – additional liability)	$80 (200 – 120)	$160 (400 – 240)	$240 (600 – 360)	$120 (600 – 480)

assistance and education credits at the same time. In addition, tax advisers should explain to their clients why including tax-exempt educational assistance in taxable income could reduce overall tax liability in some cases. Doing so will potentially add value to the services offered.

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