Optimum Use of Pell Grants and American Opportunity Tax Credit

Students May Be Foregoing Tax Benefits by Mistake.

A Treasury Fact Sheet notes that students with scholarships such as Pell Grants, who claim education-related tax credits like the American Opportunity Tax Credit (AOTC) and the Lifetime Learning Credit (LLC), may be foregoing tax credits for which they qualify. The Fact Sheet advises students and their families how to receive the maximum education tax benefits for which they are eligible.

Pell Grants (and many other scholarships) can be treated in one of two ways for tax purposes:

1. Tax-free and subtracted from AOTC-eligible expenses. Pell Grants allocated to qualified tuition and related expenses are excluded from taxable income, but they are also subtracted from qualified tuition and related expenses for purposes of the AOTC and LLC, potentially reducing the credit for which students are eligible.
2. Taxable and not subtracted from AOTC-eligible expenses. Pell Grants allocated to living expenses such as room and board are included in the student's taxable income and are not subtracted from qualified tuition and related expenses for purposes of the AOTC and LLC, potentially increasing the credit for which students are eligible.

Generally, students are allowed to decide whether to treat their Pell Grants as paying for qualified tuition and related expenses or for living expenses. A student may choose to treat his Pell Grant as paying for living expenses even if the institution applies the Pell Grant against tuition and fees. A student may allocate Pell Grant funds toward living expenses up to the amount of his actual living expenses, which may differ from the living expenses estimated by his school in computing his official cost of attendance under student aid rules. Under such an allocation:

a. Any scholarship (including a Pell Grant) must be used in a manner consistent with its terms;
b. Any scholarship that is allocated to qualified tuition and related expenses must be subtracted from qualified tuition and related expenses for purposes of the AOTC or LLC; and
c. Any scholarship that is allocated to living expenses be included in taxable income on the student's (and not the parent's) federal income tax return.

Tax strategy. Many taxpayers may be unaware that they have a choice of how to allocate scholarship funds between qualified tuition and related expenses and living expenses on their tax return. While eliminating the complexity in the AOTC and LLC would require legislation, the Fact Sheet notes that accurate and clear information can help colleges and universities, tax preparers, tax software providers, and other stakeholders help students and their families get the education tax benefits for which they are eligible.

Further, the Fact Sheet notes that the student may treat scholarship funds to have been used for non-qualified tuition and related expenses (such as room and board), simply by including the funds in income, as long as the scholarship is allowed to be used for non-qualified tuition and related expenses (as is the case with Pell Grants).

Source: Checkpoint Newsstand, November 8, 2016