

**ProSeries Education Credit Calculations
Coordination with Pell Grants and other Scholarships**

Important Note: You should **only use the following information to pursue this readjustment if both the parent and the dependent child are BOTH present at the tax site.** If either the parent or child is not present, then do not attempt to make the adjustment.

Background: Clients may be able to increase their American Opportunity Tax credit when the student (the taxpayer, their spouse or their dependent) voluntarily includes certain scholarships or fellowship grants in the student's gross income. Scholarships and fellowships that the student includes in income don't reduce the student's qualified education expenses available to figure the American Opportunity tax credit. Because the credit is calculated using only the first \$4,000 of qualified education expenses, including enough scholarship or fellowship grants in the student's income to report up to \$4,000 in qualified education expenses may increase the credit by enough to increase the amount of refund (or reduce the amount of tax owed) even though the extra income results in additional state or federal taxes for the student.

The American Opportunity Tax credit is calculated as 100% of the first \$2,000 of qualified education expenses, and 25% of the next \$2,000 of expenses. 40% of this amount is refundable. Because the first \$2,000 of expenses generates a much larger amount of credit than the next \$2,000, it can sometimes be the case that the first \$2,000 of expenses generates more credit than the additional taxes, while the next \$2,000 generates more tax than the extra credits. This is especially the case where the student is the taxpayer (or their spouse), since the extra income may reduce the amount of other credits such as the earned income credit, the child and dependent care tax credit, or the saver's tax credit, and may increase the amount of Social Security income that is taxable.

Identifying Clients Who May benefit: Once you have completed the remainder of the client's tax return, including federal and state error checks, look for the following:

1. The taxpayer who would claim the credit is not going to use the Married Filing Separately filing status – these taxpayers do not qualify for the credit in any event.
2. In the ProSeries student info worksheet, the second column from the left in line 20 of Part VI is less than \$4,000. If equal to or greater than \$4,000, the American Opportunity Tax credit is already maximized.

Where Do I Enter?

Dependent Student Info Worksheet (IMA STUDENT) Refund: \$2,645

11	Uniforms							
12	Transportation							
13	Total qualified expenses	5,500.	5,500.	5,000.	5,000.	5,500.	5,500.	5,000.
Adjustments:								
14	Refunds							
15	Tax-free assistance							
16	Deducted on Sched A							
17	Used for credit or deduction							
18	Used for exclusion		0.	0.	0.			
See tax help								
19	Total adjustments.		0.	0.	0.			
20	Adjusted qualified expenses	5,500.	5,500.	5,000.	5,000.	5,500.	5,500.	5,000.

Dependent Student Info Worksheet (IMA STUDENT) Federal Refund \$2,645

Credit already maximized

- The student had Pell grants or other scholarship or fellowship grants that may, (by their terms) be used for non-qualified expenses such as room and board.

Preliminary Calculations: For clients who may benefit from electing to make more of their scholarship income taxable, the next step is to get the details of the student's financial account showing the nature and amount of scholarship income received. This can be requested from the school and is often available on-line. Identify the different scholarships and grants and make sure that you can tie them out to what is reported on the 1098-T form (if the student received one).

- Next, split the scholarship amounts into three categories:
 - Scholarships and grants that can (by their terms) be used for non-qualified expenses. For Ladder Up clients this would include Pell grants and SEOG grants.
 - Scholarships and grants that must (by their terms) be used for tuition and other qualifying expenses. For Ladder Up clients this would include MAP grants.
 - Scholarships and grants where we do not know whether they can be used for non-qualifying expenses. Where this is the case, we either have to do more research to verify the terms (for example, by calling the financial aid office at the school) or else assume that these scholarships must be used first to cover tuition and qualifying expenses.
- Next, compare the sum of the amounts in categories b and c above to the total qualifying expenses shown in the second (American Opportunity Credit) column of line 13 of Part VI of the student info worksheet. If the total from b and c is greater than line 13, then no re-allocation is appropriate, and the return can be completed without any additional work.

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13	Total qualified expenses	5,500.	5,500.	5,000.	5,000.	5,500.	5,500.	5,000.
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See tax help								
19	Total adjustments		0.	0.	0.			
20	Adjusted qualified expenses	5,500.	5,500.	5,000.	5,000.	5,500.	5,500.	5,000.

If the sum of b and c above are greater than this number, no re-allocation is appropriate.

- Next, record the amount of both the federal and state refund or amount owed for the taxpayer and, if different, for the dependent.

Quantifying the benefit of additional taxable scholarships: Now you can explore the effects of making additional scholarship income taxable. To do this, navigate to the student info worksheet, Part V. You will be focusing on lines 5 (scholarship income), 6 (qualified expenses) and 7 (amount of scholarship income used for qualified expenses). In the example that follows, we will be working with a taxpayer who is filing as head of household, and her dependent student son who has \$5,000 of Pell grants, \$1,000 of MAP grants, and qualifying expenses of \$5,500. The taxpayer and the dependent meet all the qualifications for the taxpayer to claim the American Opportunity Tax credit. The student has no other income. Before any adjustments, the taxpayer has a federal refund of \$942, and a state refund of \$31. The dependent has no refund or amount owed for either federal or state.

Here is how Part V of the student info worksheet looks before adjustment:

Line	Description	Amount	Amount	Amount
b	Other veteran assistance or certain Indian tribal payments			
c	Other tax-free employer-provided assistance			
d	Total			
2	Scholarships, fellowships, and grants not reported on Form W-2:			
a	Scholarships and grants from Part IV above	6,000.		
b	Other scholarships, fellowships and grants			
c	Total	6,000.		
3	Scholarship reported in 2018 not allocable to 2018 expense			
4	Amount required to be used for other than qualified education expenses			
5	Subtract line 3 and 4 from line 2c	6,000.		
6	Total qualified education expenses from Part VI below	5,500.		
7	If student is a candidate for a degree, enter the amount used for qualified education expenses, otherwise, enter -0-			5,500.
8	Subtract line 7 from line 5		500.	
9	Taxable part. Add lines 4 and 8.		500.	
10	Tax-free educational assistance. Add lines 1d and 7			5,500.

Now you can do the following:

1. Line 7 in ProSeries is initially calculated by ProSeries as the lesser of line 5 scholarship income or line 6 qualified expenses, but it allows you to enter a different number.
2. Change line 7 so that it is the greater of line 6 qualified education expenses minus \$4,000, or the amount of 1b and 1c above in the Preliminary Calculations section above (scholarships that are restricted to qualified expenses or for which we do not know the terms). For this particular student, the recalculated ProSeries line 7 amount is \$1,500 and after entering that we get the following:

Line	Description	Amount	Amount	Amount
c	Other tax-free employer-provided assistance			
d	Total			
2	Scholarships, fellowships, and grants not reported on Form W-2:			
a	Scholarships and grants from Part IV above	6,000.		
b	Other scholarships, fellowships and grants			
c	Total	6,000.		
3	Scholarship reported in 2018 not allocable to 2018 expense			
4	Amount required to be used for other than qualified education expenses			
5	Subtract line 3 and 4 from line 2c	6,000.		
6	Total qualified education expenses from Part VI below	5,500.		
7	If student is a candidate for a degree, enter the amount used for qualified education expenses, otherwise, enter -0-			1,500.
8	Subtract line 7 from line 5		4,500.	
9	Taxable part. Add lines 4 and 8.		4,500.	
10	Tax-free educational assistance. Add lines 1d and 7			1,500.

3. The taxpayer now has a federal refund of \$2,645, and the state refund is unchanged at \$31.
4. The next step is to make the identical change in part V of the student info worksheet in the student's tax return. The student will have no federal tax due, but now has a state tax due of

\$223, the tax on \$4,500 of scholarship income. Before making the change, the student had \$500 of taxable scholarship income (\$6,000 of scholarship less \$5,500 of qualified expenses) and had no Illinois filing requirement. Adding another \$4,000 of income triggers an Illinois filing requirement, and, since the student is claimed as a dependent, there is no exemption amount and the full \$4,500 of income is subject to Illinois tax.

5. The total federal and state refund for the taxpayer and student combined is therefore \$2,453, a significant improvement over the initial \$973.
6. To check if a lower amount of scholarship income would produce a better result, repeat the steps above but use \$2,000 rather than \$4,000 in step 2. In this example, the ProSeries line 7 amount is then \$3,500, the taxpayer federal refund is \$2,445, the taxpayer state refund is still \$31, and the student has an Illinois amount due of \$124, so the combined refund is \$2,352. This amount is slightly lower than the amount from step 5, so we would go back and change line 7 of the student info worksheet to \$1,500 on both the taxpayer and student returns. Notice that the extra \$2,000 of qualified expenses between steps 5 and 6 produced hardly any additional tax benefit. As noted earlier, in some cases, a lower amount of qualified expenses may actually improve the result which is the reason for doing this step.

Scholarship Income and the “Kiddie Tax”: For children under age 18 and certain older children, unearned income over a certain amount is taxed using the tax rates applicable to trusts and estates. For this purpose, unearned income includes taxable scholarship and fellowship grants not reported on Form W-2. The “kiddie tax” is calculated on Form 8615, which is required when the child has more than \$2,200 of unearned income, has a federal filing requirement, and meets certain other conditions. For the purposes of determining whether the child has a federal filing requirement, taxable scholarships and fellowships are counted as **earned** income. For most Ladder Up clients, that means that there will be no filing requirement, and therefore no requirement for Form 8615, until the child’s taxable scholarship and fellowship income plus other income exceeds the federal filing requirement (\$12,200 for 2019).

Once a dependent child has more than \$2,200 of taxable scholarship income, ProSeries automatically opens a Form 8615, even if none is required because the student has no filing requirement. Navigate to Form 8615 and near the top locate the “Child Age 18 to 23 Smart Worksheet”. Answering “No” to the question in this block will suppress the Form 8615 even where one is required, and answering “Yes” will create a need to supply the parent’s name and SSN, even where there is no filing requirement and Form 8615 is not required. Moreover, the question asked in the worksheet does not line up with the Form 8615 instructions, which refer to **unearned income** being more than \$2,200, while the worksheet asks only about **investment income**. For these reasons, mark the “No” box unless the student has a federal filing requirement. If they do have a federal filing requirement, then answer the question substituting **unearned income** where the question asks for **investment income**. When you have finally decided what level of scholarship income to make taxable, do a final manual check to determine if Form 8615 is required and make sure that it is populated if needed and suppressed otherwise.

In testing several different levels of scholarship income, some may trigger the “kiddie tax” and others may not, so make sure you review the situation carefully for each scenario.

Note that for tax years 2017 and earlier the “kiddie tax” was calculated using the parent’s marginal tax rates and is out of scope for VITA, so be careful that you do not trigger the “kiddie tax” for earlier years.

Other Requirements: Electing to make more of the scholarship income taxable can significantly increase the amount of education benefits, but it is also a complicated process especially when the student is a dependent child. In order to make more of the scholarship income taxable, Ladder Up requires that:

1. The return(s) be quality reviewed by a volunteer certified at the Advanced level who is familiar with both the tax rules and the ProSeries handling of such returns.
2. We have a copy of the student's financial account to verify the amount and types of scholarships and grants appearing on the 1098-T.
3. Before finalizing the parent's return, we need to prepare the student's return (or see a copy of it) including the appropriate amount of scholarship income on both the federal and state returns. Frequently a parent will say that the student is not filing a return, but with added taxable income an Illinois return will almost always be required, and in any event, we need to verify any other student income with the student. We may be able to give the parent a rough estimate of the benefits of making more scholarship income taxable, and then they can decide if they want to proceed without this, wait until later in the year to complete their return, or file now without the higher scholarship income and return later with the student to amend the return (because amendments take many months for the IRS to process, this is not the best approach.)
4. So that we have a record of what was done in case of future client or IRS questions, make a note in the "Additional Comments" section of Form 13614-C for both the taxpayer and (if different) the student explaining that you did the re-allocation. This should include documentation of both the types and amounts of grants that were re-allocated.
5. *Optional:* ProSeries also allows notes to be entered which will be visible to the tax preparer the following year if the file is transferred. This is useful since the preparer likely will not have access to the prior year 13614-C and clients may have questions why their American Opportunity Credit amounts differ from year to year even though other things didn't change. To create a note, click on the little yellow pencil at the top of the screen (look to the right of the ST button used to prepare the Illinois return). Type in an appropriate note (can be identical to the 13614-C comments. Adding a note in ProSeries does NOT replace making a notation on the 13614-C page 3, as VITA requires the use of the 13614-C). **If you do make a note in ProSeries, make sure the box "Print this note as part of the tax return for filing" is not checked before printing.**

**Coordinating Pell Grants to Optimize the American Opportunity Tax Credit
Optional Worksheet**

Identifying Clients Who May Benefit

After completing the federal and state tax returns for the taxpayer and (if different) the student, check the following:

Is taxpayer Married Filing Separately?

Yes: **STOP!** Taxpayer not eligible for education credits

No: Continue

Is the amount in column 2 (the AOTC column) line 20 of Part VI of the ProSeries student info worksheet equal to or greater than \$4,000?

Yes: **STOP!** Credit is already maximized

No: Continue

Does the student have Pell grants or other grants that can, by their terms, be used for other than qualified expenses?

Yes: Continue

No: **Stop!** Only such grants can be elected as taxable

Preliminary calculations

1 (a) Scholarships that *may* be used for other than qualifying expenses _____ 1 (a)

1 (b) Scholarships that *must* be used for qualifying expenses _____ 1 (b)

Scholarships where we *do not know* whether they can be used for other

1 (c) than qualifying expenses _____ 1 (c)

1 (d) Sum of 1(b) and 1 (c) _____ 1 (d)

2 Total qualified expenses from line 13 of column 2 (the AOTC column) of Part VI of the ProSeries student info worksheet _____ 2

Is the number on line 1 (d) greater than the number on line 2?

Yes: **STOP!** No additional scholarship income can be made taxable

No: Continue

3 Record the taxpayer (and student if different) refund/amount due on the next sheet

Navigate to the ProSeries student info worksheet Part V and record:

4 Current amount in line 7 of Part V: _____ 4

5 Amount in line 6 of Part V: _____ 5

6 Calculate: Line 5 above minus \$4,000 _____ 6

Is line 6 above greater than line 1(d) above?

Yes: Enter line 6 above into line 7 of Part V of the ProSeries student info worksheet

No: Enter line 1(d) above into line 7 of Part V of the ProSeries student info worksheet

7 Do for both taxpayer and student, clear any errors, and record new federal and state refunds/amount due on the next sheet in the \$4,000 area

8 Calculate: Line 55 above minus \$2,000 _____ 8

Is line 8 above greater than line 1(d) above?

Yes: Enter line 8 above into line 7 of Part V of the ProSeries student info worksheet

No: Enter line 1(d) above into line 7 of Part V of the ProSeries student info worksheet

9 Do for both taxpayer and student, clear any errors, and record new federal and state refunds/amount due on the next sheet in the \$2,000 area

**Coordinating Pell Grants to Optimize the American Opportunity Tax Credit
Optional Worksheet (Page 2)**

Results:

Base case: Record the taxpayer and (if different) student federal and state refunds/(amount owed) before any adjustment to make more income taxable (step 3 above)

	Federal	State	Total
Taxpayer:	<hr/>		
Student (only if different):	<hr/>		
Total	XXXXXXXX	XXXXXXXX	<input type="text"/> 10

\$4,000 case: Record the taxpayer and (if different) student federal and state refunds/(amount owed) after step 7 above

	Federal	State	Total
Taxpayer:	<hr/>		
Student (only if different):	<hr/>		
Total	XXXXXXXX	XXXXXXXX	<input type="text"/> 11

\$2,000 case: Record the taxpayer and (if different) student federal and state refunds/(amount owed) after step 9 above

	Federal	State	Total
Taxpayer:	<hr/>		
Student (only if different):	<hr/>		
Total	XXXXXXXX	XXXXXXXX	<input type="text"/> 12

As a final step, determine whether the best result is in box 10, 11 or 12. Go back to ProSeries and make sure that you change line 7 back to the amount that generated that result.