

Section 25A.—Hope and Lifetime Learning Credits

26 CFR 1.25A-1: Calculation of education tax credit and general eligibility requirements.

T.D. 9034

DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Parts 1 and 602

Education Tax Credit

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to the Hope Scholarship Credit and the Lifetime Learning Credit under section 25A of the Internal Revenue Code. The final regulations reflect changes made to the law by the Taxpayer Relief Act of 1997. These regulations provide guidance to individuals who may claim the Hope Scholarship Credit or the Lifetime Learning Credit for the payment of certain postsecondary educational expenses.

DATES: *Effective Date:* These regulations are effective December 26, 2002.

Applicability Dates: For dates of applicability, see § 1.25A-3(f) and § 1.25A-4(d).

FOR FURTHER INFORMATION CONTACT: Marilyn E. Brookens, (202) 622-4920 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in these final regulations has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507) under control number 1545-1630. Responses to this collection of information are mandatory.

The collection of information is in § 1.25A-1(d) and (f). Taxpayers must elect to claim an education credit by attaching Form 8863, “*Education Credits (Hope and*

Lifetime Learning Credits),” to a federal income tax return for the taxable year in which a credit is claimed. This collection of information is required in order for a taxpayer to elect to claim an education credit. This information will be used to carry out the internal revenue laws. The likely respondents are individuals.

The reporting burden contained in § 1.25A-1(d) and (f) is reflected in the burden of Form 8863, “*Education Credits (Hope and Lifetime Learning Credits)*,” and Form 1040, “*U.S. Individual Income Tax Return*.”

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a valid control number.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Background

This document contains amendments to the Income Tax Regulations (26 CFR part 1) regarding the Hope Scholarship Credit and the Lifetime Learning Credit (education tax credit) under section 25A of the Internal Revenue Code. The Taxpayer Relief Act of 1997 (Public Law 105-34 (111 Stat. 788) (TRA '97)) added section 25A to provide the education tax credit. In general, the education tax credit allows taxpayers to claim a nonrefundable credit against their federal income tax for the payment of certain postsecondary educational expenses. The Economic Growth and Tax Relief Reconciliation Act of 2001 (Public Law 107-16 (115 Stat. 38)) added section 222 of the Internal Revenue Code to provide an above-the-line deduction for certain postsecondary education expenses paid in taxable years beginning after December 31, 2001, and before January 1, 2006. Section 222 is an alternative to section 25A, and taxpayers cannot claim a section 222 deduction and a section 25A education tax credit in the same year with respect to the same student.

On November 17, 1997, the IRS published Notice 97-60, 1997-2 C.B. 310, to provide general guidance on the higher edu-

cation tax incentives enacted by TRA '97, including the education tax credit. A notice of proposed rulemaking (REG-106388-98, 1999-1 C.B. 756 [64 FR 794]) was published in the **Federal Register** on January 6, 1999. One request for a public hearing was received. However, the request was withdrawn, and no public hearing was held. The IRS received written and electronic comments responding to the notice of proposed rulemaking. After consideration of all the comments, the proposed regulations are adopted as amended by this Treasury decision. The revisions are discussed below.

Explanation of Provisions and Summary of Comments

1. Reporting Requirements Under Section 6050S for Eligible Educational Institutions

Many commentators requested clarification of the information reporting requirements under section 6050S for eligible educational institutions (institutions) that receive payments of qualified tuition and related expenses (qualified expenses). These comments are outside the scope of section 25A, which relates solely to the education tax credit allowable to taxpayers for payments of qualified expenses. However, these comments were considered by the IRS and the Treasury Department in drafting the proposed regulations under section 6050S that were published in the **Federal Register** (REG-161424-01, 2002-21 I.R.B. 1010 [67 FR 20923]) on April 29, 2002.

2. Calculation of Education Tax Credit and General Eligibility Requirements

Several commentators recommended changes to the rules for calculating the amount of any allowable education tax credit. One commentator recommended that the calculation of the Hope Scholarship Credit be simplified so that the credit is allowable for the first \$1,500 of qualified expenses, rather than 100 percent of the first \$1,000 of qualified expenses, and 50 percent of the next \$1,000 of qualified expenses as provided in section 25A(b)(1). This commentator also recommended that the calculation of the Lifetime Learning

Credit be simplified so that the credit is allowable for the first \$1,000 of qualified expenses, rather than 20 percent of the first \$5,000 of qualified expenses as provided in section 25A(c)(1). Another commentator recommended that, for purposes of the income limitations in section 25A(d), income realized on the conversion of a traditional Individual Retirement Account (IRA) to a Roth IRA should be excluded from the definition of modified adjusted gross income. The rules in the proposed regulations regarding calculation of the amount of the education tax credit and the definition of modified adjusted gross income derive from the statutory provisions of section 25A. Therefore, the final regulations do not adopt these recommendations.

Commentators requested clarification of the rules for claiming the education tax credit in the case of a dependent. Consistent with the legislative history to section 25A, § 1.25A-1(g) of the proposed regulations provides that if a student is a claimed dependent of a taxpayer, only that taxpayer may claim the education tax credit for the student's qualified expenses; however, if the taxpayer is eligible to, but does not claim the student as a dependent, only the student may claim the education tax credit for the student's qualified expenses. The final regulations retain this rule.

Commentators asked how the student's personal exemption deduction amount under section 151 is calculated if a parent does not claim the student as a dependent on the parent's income tax return in order that the student may claim the education tax credit on the student's income tax return. Section 151(d)(2) provides a special rule for calculating the exemption deduction amount in the case of an individual (for example, a student) for whom a dependency exemption deduction is allowable to another taxpayer (for example, a parent). Under this rule, a student's personal exemption deduction amount is zero on the student's income tax return if a parent is eligible to claim the student as a dependent even if the parent does not in fact claim a dependency exemption deduction for the student. The result is the same if the amount of the dependency exemption deduction allowable to the parent is reduced or eliminated under the phase-out rule in section 151(d)(3).

Consistent with section 25A(g)(7), the proposed regulations provide that a non-

resident alien individual is not eligible to claim an education tax credit, unless the individual is treated as a resident alien of the United States by reason of an election under section 6013(g) or (h). One commentator suggested that *Examples 7 and 8* in § 1.25A-3(d)(2) of the proposed regulations should be revised to avoid any confusion about the eligibility of a nonresident alien student to claim an education tax credit. The final regulations modify these examples to avoid any implication that a nonresident alien student may claim an education tax credit, in the absence of an election under section 6013(g) or (h).

Another commentator requested clarification as to whether a nonresident alien individual who elects to be treated as a resident alien may claim an education tax credit. A limited number of income tax treaties allow certain individuals to elect to be treated as residents of the United States. Because such an election is intended to apply for all tax purposes, an individual for whom a valid election under a treaty is in effect is treated as a resident for purposes of section 25A.

3. Definitions

Several commentators requested clarification of the definition of *academic period*. The proposed regulations provide that academic period means a quarter, semester, trimester, or other period of study (such as a summer school session) as reasonably determined by the eligible educational institution. As stated in the preamble of the proposed regulations, this definition is intended to include institutions that use traditional academic terms and institutions that do not use academic terms, but for example use clock hours or credit hours. The IRS and the Treasury Department invited comments on the proposed definition. One commentator suggested that the final regulations provide that, in the case of institutions that use clock hours or credit hours, but do not use traditional academic terms, the term academic period may include a *payment period* as defined by the Department of Education in 34 CFR 668.4. The final regulations adopt this recommendation.

Several commentators requested clarification of the definition of *qualified tuition and related expenses*. The proposed regulations define qualified tuition and related expenses to mean tuition and fees re-

quired for the enrollment or attendance of a student for courses of instruction at an eligible educational institution. The proposed regulations provide that, in general, the test for determining whether a fee is a qualified expense is whether the fee is required to be paid to the institution as a condition of the student's enrollment or attendance at the institution. However, the proposed regulations also provide that qualified expenses do not include the costs of room and board, insurance, medical expenses, transportation, and similar personal, living, or family expenses, regardless of whether the payment of such fees is required for the student's enrollment or attendance. The final regulations retain these rules.

One commentator requested clarification as to whether an education tax credit is allowable for amounts paid in one year for an independent study course which the student has up to two years to complete. The proposed regulations provide that qualified expenses paid in one taxable year may qualify for an education tax credit in the year of the payment if the expenses relate to education furnished during an academic period beginning in the year of payment or within the first three months of the next taxable year. The final regulations retain this rule. Therefore, an education tax credit is allowable for qualified expenses paid in one taxable year for independent study during an academic period that begins in the taxable year of payment or within the first three months of the next taxable year.

One commentator requested clarification as to when amounts paid for books are qualified expenses. The proposed regulations provide that, in general, an education tax credit is not available for expenses incurred to purchase books. The final regulations continue to provide that qualified expenses include fees for books, supplies, and equipment used in a course of study only if the fees must be paid to the institution for the enrollment or attendance of the student at the institution. In this situation, the amount paid for books is a required fee.

Other commentators requested clarification as to whether a required student health service fee and a required transportation fee are qualified expenses. Consistent with the legislative history to section 25A, the final regulations continue to provide that qualified expenses do not include fees for room and board, insurance,

medical expenses, transportation, and similar personal, living, or family expenses, regardless of whether the fee must be paid to the institution as a condition of the student's enrollment or attendance. Therefore, a required student health fee and a required transportation fee are not qualified expenses. The final regulations clarify that, as stated in the preamble to the proposed regulations, medical expenses include student health fees.

Several commentators requested clarification of how a required general fee (referred to as a *bundled fee*) should be treated in calculating the amount of qualified expenses. These commentators explained that often institutions will charge a bundled fee that includes charges for both qualified expenses and personal expenses. These commentators note that, unlike a comprehensive fee, a bundled fee normally does not include tuition charges.

Section 1.25A-2(d)(4) of the proposed regulations describes the treatment of a comprehensive fee, which typically includes charges for tuition, fees, and personal expenses. The proposed regulations provide that the portion of the comprehensive fee that is allocable to personal expenses is not a qualified expense, and require institutions to make a reasonable allocation between qualified expenses and personal expenses. One commentator recommended that the final regulations provide a similar allocation rule for bundled fees. Another commentator recommended that institutions should not be required to allocate a bundled fee that includes an insubstantial amount of personal expenses. Because personal expenses do not qualify for the education tax credit, the final regulations clarify that the allocation rule in § 1.25A-2(d)(4) applies to any required fee that combines charges for both qualified expenses and personal expenses (such as comprehensive fees and bundled fees).

One commentator noted that, under the definition of a *hobby course* in § 1.25A-2(d)(5) of the proposed regulations, one student may be enrolled in a course to receive academic credit toward a degree, another student may be enrolled in the same course on a noncredit basis to acquire or improve job skills, while a third student may be enrolled in the same course as a hobby. Under the proposed regulations, the first and second students may be eligible to claim an

education tax credit, but the third student is not. Consistent with sections 25A(c)(2) and 25A(f)(1)(B), the final regulations continue to provide that expenses paid for courses that involve sports, games, or hobbies, or any noncredit course, are not qualified expenses, unless the course is part of the individual's degree program, or, in the case of the Lifetime Learning Credit, the student takes the course to acquire or improve job skills.

4. Hope Scholarship Credit

Several commentators requested clarification of the definition of an *eligible student* for purposes of the Hope Scholarship Credit. One commentator recommended that the *year of study requirement* in the regulations should be eliminated and that the credit should be allowed for any two years of undergraduate study. The year of study requirement derives from the statutory requirements in section 25A. Therefore, the final regulations do not adopt this recommendation.

Another commentator requested clarification as to whether a student who completes a one-year postsecondary certificate program and in a later year completes another one-year postsecondary certificate program (or enrolls in a postsecondary degree program) may claim a Hope Scholarship Credit for both years. The final regulations include a new example in § 1.25A-3(d)(2) that illustrates that the Hope Scholarship Credit is allowable for the first two years of postsecondary education, which may include two one-year certificate programs.

Commentators requested clarification of *Example 3* in § 1.25A-3(d)(2). The commentators asked if an otherwise eligible student who has not completed the first two years of undergraduate study as of the beginning of the taxable year may include qualified expenses paid during the entire taxable year in calculating the Hope Scholarship Credit, even if the student completes the first two years of undergraduate study during the year. The example has been revised to clarify that, if a student has not completed the first two years of undergraduate study as of the beginning of the taxable year, the qualified expenses paid during the entire taxable year may be taken into account in calculating the Hope Scholarship Credit. However, in no event may a

Hope Scholarship Credit be claimed for more than two taxable years with respect to the same student.

5. Special Rules Relating to Characterization and Timing of Payments

Several commentators requested clarification of the rules for payments of qualified expenses by a third party. One commentator asked how the third party payment rule in § 1.25A-5 of the proposed regulations applies in the case of a taxpayer who, although not divorced, is not treated as married within the meaning of section 7703. The proposed regulations provide that if a third party (someone other than the taxpayer, the taxpayer's spouse, or a claimed dependent) pays qualified expenses on behalf of a student directly to an institution, the student is treated as receiving the payment from the third party and, in turn, paying the qualified expenses to the institution. The final regulations clarify that, for purposes of § 1.25A-5(b), a third party includes the spouse of a taxpayer who is not treated as married under section 7703. Thus, for example, if the taxpayer is a custodial parent who is not treated as married under section 7703, then (assuming that the taxpayer claims the student as a dependent) the taxpayer may claim an education tax credit for qualified expenses paid by the noncustodial parent on behalf of the student.

One commentator requested clarification as to whether an education tax credit is allowable for the amount of any tuition reduction provided by an eligible educational institution to its employees, or their spouses or dependent children. The final regulations provide in § 1.25A-5(b)(2) that an education tax credit is allowable for the amount of any reduction in tuition only if the amount of the tuition reduction is included in the employee's gross income.

Several commentators requested clarification of the rules in § 1.25A-5(c) of the proposed regulations for reducing the amount of qualified expenses paid during the taxable year by the amount of certain tax-free educational assistance (including any qualified scholarship that is excluded from gross income under section 117) received during the taxable year. The pro-

posed regulations provide a rule for allocating scholarships between qualified expenses and expenses that do not qualify for an education tax credit under section 25A (nonqualified expenses). The proposed regulations provide that a scholarship will be treated as allocated to qualified expenses, and thus as a qualified scholarship that reduces qualified expenses, unless the student includes the scholarship in income or the terms of the scholarship require that it be applied to nonqualified expenses.

Several commentators asked whether a student may choose to include in income a restricted scholarship that, by its terms, must be used to pay qualified expenses and claim an education tax credit for qualified expenses covered by the scholarship. The test for purposes of section 25A is whether the scholarship is excludable from gross income under section 117, and not whether the student elects to include the scholarship in income. The legislative history to section 25A states that qualified expenses do not include expenses covered by "education assistance that is not required to be included in the gross income of either the student or the taxpayer claiming the credit." See H.R. Conf. Rep. No. 220, 105th Cong., 1st Sess., at 343 (1997). Section 117 provides, in general, that gross income shall not include a scholarship that, consistent with the terms of the scholarship, is used to pay certain qualified expenses. A restricted scholarship that must be used to pay qualified expenses is a qualified scholarship excludable under section 117. Therefore, for purposes of section 25A, a restricted scholarship that must be used to pay qualified expenses reduces the amount of qualified expenses that may be taken into account in calculating the education tax credit.

An unrestricted scholarship that may be used to pay any of the student's costs of attendance (such as room and board and any other incidental expenses) is excludable from gross income only if used to pay qualified expenses. To the extent that an unrestricted scholarship, or a portion thereof, is used to pay nonqualified expenses and such use is consistent with the terms of the scholarship, the scholarship is not a qualified scholarship excludable under section 117. In this situation, the scholarship is included in gross income and will not reduce the amount of qualified expenses that

may be taken into account in calculating the education tax credit. The final regulations clarify that, for purposes of section 25A, a scholarship or fellowship grant is treated as a qualified scholarship excludable under section 117 (thereby reducing the amount of qualified expenses) except to the extent: (1) the scholarship may be applied, by its terms, to expenses other than qualified expenses (such as room and board) and the student reports the scholarship as income; or (2) the scholarship must be applied, by its terms, to expenses other than qualified expenses (such as room and board) and the student reports the scholarship as income.

One commentator recommended that the final regulations provide that loans are not excludable educational assistance within the meaning of § 1.25A-5(c), and do not reduce the amount of qualified expenses. Section 1.25A-5(e)(3) of the proposed regulations specifically provides that amounts paid with loan proceeds may qualify for the education tax credit. In addition, an example in § 1.25A-5(c)(4) of the proposed regulations provides that a loan is not tax-free educational assistance within the meaning of § 1.25A-5(c). The final regulations retain these specific provisions on loans.

The proposed regulations provide that expenses paid with loan proceeds disbursed directly to an institution are, in general, treated as paid on the date of the disbursement of the proceeds. Several commentators recommended that, in accordance with the Department of Education regulations in 34 CFR 668.164(a), the date of disbursement should be the date the institution credits the student's account with the loan proceeds and not the date the lender disburses the loan proceeds to the institution. In general, 34 CFR 668.164 regulates the disbursement of federal student loans under Title IV of the Higher Education Act of 1965 (including the Federal Perkins Loan, Federal Family Education Loan, and William D. Ford Direct Loan Program). These rules require an institution to verify that a student is enrolled and is otherwise eligible to receive the loan proceeds before crediting the student's account or releasing the funds to the student. Consistent with these Department of Education rules, the final regulations clarify that the qualified expenses paid with loan proceeds disbursed directly to an institution are treated as paid at the time the loan proceeds are ac-

tually credited to the student's account. In the case of Title IV loan programs, Department of Education rules require the institution to notify the borrower of the date and the amount of the disbursement at the time the institution credits the student's account. See 34 CFR 668.165(a)(2). However, the final regulations provide that if the taxpayer does not know the date the institution credits the student's account, the taxpayer must treat the expenses as paid on the last date for payment prescribed by the institution.

Several commentators requested clarification as to when a taxpayer may claim an education tax credit for qualified expenses paid through a third party installment payment plan. One commentator explained that institutions and taxpayers may contract with a third party installment payment company to provide an installment payment plan for the institution's students. The commentator explained that, in general, the company agrees to collect tuition payments over a period of time (usually 10 months) and remit the payments to the institution on a predetermined schedule. The commentator asked whether a taxpayer is treated as paying the qualified expenses when the taxpayer pays the third party installment payment company, or when the third party disburses the funds to the institution. The final regulations clarify that when the expenses are treated as paid for purposes of section 25A depends on whether, under the terms of the installment payment agreement, the third party is acting as an agent of the taxpayer or as an agent of the institution.

One commentator requested clarification as to whether an education tax credit is allowable for any amounts paid for qualified expenses that are retained by the institution, under the institution's refund policy, when the student withdraws. Section 1.25A-5(f)(1) of the proposed regulations provides that the amount of qualified expenses is calculated by adding all the qualified expenses paid for the year, and subtracting any refund received from the institution during the same year. The final regulations retain this rule. Therefore, amounts required to be paid for enrollment or attendance are qualified expenses to the extent that such amounts are not refunded when the student withdraws. The final regulations add a new paragraph § 1.25A-5(f)(4) to clarify that, with re-

spect to qualified expenses paid with the proceeds of a loan, any refund of loan proceeds by the institution back to the lender on behalf of the borrower is treated as a refund of qualified expenses.

The proposed regulations provide that if a taxpayer receives a refund of qualified expenses paid in a prior taxable year before the taxpayer files a federal income tax return for the prior year, the amount of qualified expenses for the prior taxable year is reduced by the amount of the refund. One commentator suggested that the taxpayer should have the option of claiming the credit for the full amount of qualified expenses paid in the prior taxable year and then recapturing the credit on the return filed for the taxable year in which the refund was received. The rule in the proposed regulations is intended to simplify the calculation of the education tax credit by avoiding the need to recompute the allowable education tax credit in a later year and report any resulting increase in tax. Therefore, the final regulations do not adopt the recommendation.

The final regulations clarify that, in the case of a payment of qualified expenses in one taxable year and a refund of qualified expenses in a subsequent taxable year, the recapture amount for the refund year is the difference in tax liability for the prior taxable year (taking into account any redetermination of such tax liability by audit or amended return) that results when the tax liability for the prior year is calculated using the taxpayer's redetermined credit.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Internal Revenue Code, the proposed regulations preceding these regulations were submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal author of the regulations is Donna Welch, Office of Associate Chief Counsel (Procedure & Administration), Administrative Provisions & Judicial Practice Division. However, other personnel from the IRS and the Treasury Department participated in the development of the regulations.

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding entries in numerical order to read as follows:

Authority: 26 U.S.C. 7805 * * *

Section 1.25A-1 also issued under section 26 U.S.C. 25A(i).

Section 1.25A-2 also issued under section 26 U.S.C. 25A(i).

Section 1.25A-3 also issued under section 26 U.S.C. 25A(i).

Section 1.25A-4 also issued under section 26 U.S.C. 25A(i).

Section 1.25A-5 also issued under section 26 U.S.C. 25A(i). * * *

Par. 2. Sections 1.25A-0 through 1.25A-5 are added to read as follows:

§ 1.25A-0 Table of contents.

This section lists captions contained in §§ 1.25A-1, 1.25A-2, 1.25A-3, 1.25A-4, and 1.25A-5.

§ 1.25A-1 Calculation of education tax credit and general eligibility requirements.

- (a) Amount of education tax credit.
- (b) Coordination of Hope Scholarship Credit and Lifetime Learning Credit.
 - (1) In general.
 - (2) Hope Scholarship Credit.
 - (3) Lifetime Learning Credit.
 - (4) Examples.
- (c) Limitation based on modified adjusted gross income.
 - (1) In general.
 - (2) Modified adjusted gross income defined.
 - (3) Inflation adjustment.
 - (d) Election.

- (e) Identification requirement.
- (f) Claiming the credit in the case of a dependent.
 - (1) In general.
 - (2) Examples.
 - (g) Married taxpayers.
 - (h) Nonresident alien taxpayers and dependents.

§ 1.25A-2 Definitions.

- (a) Claimed dependent.
- (b) Eligible educational institution.
 - (1) In general.
 - (2) Rules on federal financial aid programs.
 - (c) Academic period.
 - (d) Qualified tuition and related expenses.

- (1) In general.
- (2) Required fees.
 - (i) In general.
 - (ii) Books, supplies, and equipment.
 - (iii) Nonacademic fees.
- (3) Personal expenses.
- (4) Treatment of a comprehensive or bundled fee.
- (5) Hobby courses.
- (6) Examples.

§ 1.25A-3 Hope Scholarship Credit.

- (a) Amount of the credit.
 - (1) In general.
 - (2) Maximum credit.
- (b) Per student credit.
 - (1) In general.
 - (2) Example.
 - (c) Credit allowed for only two taxable years.
 - (d) Eligible student.
 - (1) Eligible student defined.
 - (i) Degree requirement.
 - (ii) Work load requirement.
 - (iii) Year of study requirement.
 - (iv) No felony drug conviction.
 - (2) Examples.
 - (e) Academic period for prepayments.
 - (1) In general.
 - (2) Example.
 - (f) Effective date.

§ 1.25A-4 Lifetime Learning Credit.

- (a) Amount of the credit.
 - (1) Taxable years beginning before January 1, 2003.
 - (2) Taxable years beginning after December 31, 2002.
 - (3) Coordination with the Hope Scholarship Credit.

(4) Examples.

(b) Credit allowed for unlimited number of taxable years.

(c) Both degree and nondegree courses are eligible for the credit.

(1) In general.

(2) Examples.

(d) Effective date.

§ 1.25A-5 Special rules relating to characterization and timing of payments.

(a) Educational expenses paid by claimed dependent.

(b) Educational expenses paid by a third party.

(1) In general.

(2) Special rule for tuition reduction included in gross income of employee.

(3) Examples.

(c) Adjustment to qualified tuition and related expenses for certain excludable educational assistance.

(1) In general.

(2) No adjustment for excludable educational assistance attributable to expenses paid in a prior year.

(3) Scholarships and fellowship grants.

(4) Examples.

(d) No double benefit.

(e) Timing rules.

(1) In general.

(2) Prepayment rule.

(i) In general.

(ii) Example.

(3) Expenses paid with loan proceeds.

(4) Expenses paid through third party installment payment plans.

(i) In general.

(ii) Example.

(f) Refund of qualified tuition and related expenses.

(1) Payment and refund of qualified tuition and related expenses in the same taxable year.

(2) Payment of qualified tuition and related expenses in one taxable year and refund in subsequent taxable year before return filed for prior taxable year.

(3) Payment of qualified tuition and related expenses in one taxable year and refund in subsequent taxable year.

(i) In general.

(ii) Recapture amount.

(4) Refund of loan proceeds treated as refund of qualified tuition and related expenses.

(5) Excludable educational assistance received in a subsequent taxable year treated

as a refund.

(6) Examples.

§ 1.25A-1 Calculation of education tax credit and general eligibility requirements.

(a) *Amount of education tax credit.* An individual taxpayer is allowed a nonrefundable education tax credit against income tax imposed by chapter 1 of the Internal Revenue Code for the taxable year. The amount of the education tax credit is the total of the Hope Scholarship Credit (as described in § 1.25A-3) plus the Lifetime Learning Credit (as described in § 1.25A-4). For limitations on the credits allowed by subpart A of part IV of subchapter A of chapter 1 of the Internal Revenue Code, see section 26.

(b) *Coordination of Hope Scholarship Credit and Lifetime Learning Credit—(1) In general.* In the same taxable year, a taxpayer may claim a Hope Scholarship Credit for each eligible student's qualified tuition and related expenses (as defined in § 1.25A-2(d)) and a Lifetime Learning Credit for one or more other students' qualified tuition and related expenses. However, a taxpayer may not claim both a Hope Scholarship Credit and a Lifetime Learning Credit with respect to the same student in the same taxable year.

(2) *Hope Scholarship Credit.* Subject to certain limitations, a Hope Scholarship Credit may be claimed for the qualified tuition and related expenses paid during a taxable year with respect to each eligible student (as defined in § 1.25A-3(d)). Qualified tuition and related expenses paid during a taxable year with respect to one student may not be taken into account in computing the amount of the Hope Scholarship Credit with respect to any other student. In addition, qualified tuition and related expenses paid during a taxable year with respect to any student for whom a Hope Scholarship Credit is claimed may not be taken into account in computing the amount of the Lifetime Learning Credit.

(3) *Lifetime Learning Credit.* Subject to certain limitations, a Lifetime Learning Credit may be claimed for the aggregate amount of qualified tuition and related expenses paid during a taxable year with respect to students for whom no Hope Scholarship Credit is claimed.

(4) *Examples.* The following examples illustrate the rules of this paragraph (b):

Example 1. In 1999, Taxpayer A pays qualified tuition and related expenses for his dependent, B, to attend College Y during 1999. Assuming all other relevant requirements are met, Taxpayer A may claim either a Hope Scholarship Credit or a Lifetime Learning Credit with respect to dependent B, but not both. See § 1.25A-3(a) and § 1.25A-4(a).

Example 2. In 1999, Taxpayer C pays \$2,000 in qualified tuition and related expenses for her dependent, D, to attend College Z during 1999. In 1999, Taxpayer C also pays \$500 in qualified tuition and related expenses to attend a computer course during 1999 to improve Taxpayer C's job skills. Assuming all other relevant requirements are met, Taxpayer C may claim a Hope Scholarship Credit for the \$2,000 of qualified tuition and related expenses attributable to dependent D (see § 1.25A-3(a)) and a Lifetime Learning Credit (see § 1.25A-4(a)) for the \$500 of qualified tuition and related expenses incurred to improve her job skills.

Example 3. The facts are the same as in *Example 2*, except that Taxpayer C pays \$3,000 in qualified tuition and related expenses for her dependent, D, to attend College Z during 1999. Although a Hope Scholarship Credit is available only with respect to the first \$2,000 of qualified tuition and related expenses paid with respect to D (see § 1.25A-3(a)), Taxpayer C may not add the \$1,000 of excess expenses to her \$500 of qualified tuition and related expenses in computing the amount of the Lifetime Learning Credit.

(c) *Limitation based on modified adjusted gross income—(1) In general.* The education tax credit that a taxpayer may otherwise claim is phased out ratably for taxpayers with modified adjusted gross income between \$40,000 and \$50,000 (\$80,000 and \$100,000 for married individuals who file a joint return). Thus, taxpayers with modified adjusted gross income above \$50,000 (or \$100,000 for joint filers) may not claim an education tax credit.

(2) *Modified adjusted gross income defined.* The term *modified adjusted gross income* means the adjusted gross income (as defined in section 62) of the taxpayer for the taxable year increased by any amount excluded from gross income under section 911, 931, or 933 (relating to income earned abroad or from certain U.S. possessions or Puerto Rico).

(3) *Inflation adjustment.* For taxable years beginning after 2001, the amounts in paragraph (c)(1) of this section will be increased for inflation occurring after 2000 in accordance with section 1(f)(3). If any amount adjusted under this paragraph (c)(3) is not a multiple of \$1,000, the amount will be rounded to the next lowest multiple of \$1,000.

(d) *Election.* No education tax credit is allowed unless a taxpayer elects to claim the credit on the taxpayer's federal income tax return for the taxable year in

which the credit is claimed. The election is made by attaching Form 8863, “*Education Credits (Hope and Lifetime Learning Credits)*,” to the federal income tax return.

(e) *Identification requirement.* No education tax credit is allowed unless a taxpayer includes on the federal income tax return claiming the credit the name and the taxpayer identification number of the student for whom the credit is claimed. For rules relating to assessment for an omission of a correct taxpayer identification number, see sections 6213(b) and (g)(2)(J).

(f) *Claiming the credit in the case of a dependent—(1) In general.* If a student is a claimed dependent of another taxpayer, only that taxpayer may claim the education tax credit for the student’s qualified tuition and related expenses. However, if another taxpayer is eligible to, but does not, claim the student as a dependent, only the student may claim the education tax credit for the student’s qualified tuition and related expenses.

(2) *Examples.* The following examples illustrate the rules of this paragraph (f):

Example 1. In 1999, Taxpayer A pays qualified tuition and related expenses for his dependent, B, to attend University Y during 1999. Taxpayer A claims B as a dependent on his federal income tax return. Therefore, assuming all other relevant requirements are met, Taxpayer A is allowed an education tax credit on his federal income tax return, and B is not allowed an education tax credit on B’s federal income tax return. The result would be the same if B paid the qualified tuition and related expenses. See § 1.25A–5(a).

Example 2. In 1999, Taxpayer C has one dependent, D. In 1999, D pays qualified tuition and related expenses to attend University Z during 1999. Although Taxpayer C is eligible to claim D as a dependent on her federal income tax return, she does not do so. Therefore, assuming all other relevant requirements are met, D is allowed an education tax credit on D’s federal income tax return, and Taxpayer C is not allowed an education tax credit on her federal income tax return, with respect to D’s education expenses. The result would be the same if C paid the qualified tuition and related expenses on behalf of D. See § 1.25A–5(b).

(g) *Married taxpayers.* If a taxpayer is married (within the meaning of section 7703), no education tax credit is allowed to the taxpayer unless the taxpayer and the taxpayer’s spouse file a joint federal income tax return for the taxable year.

(h) *Nonresident alien taxpayers and dependents.* If a taxpayer or the taxpayer’s spouse is a nonresident alien for any portion of the taxable year, no education tax credit is allowed unless the nonresident alien is treated as a resident alien by reason of

an election under section 6013(g) or (h). In addition, if a student is a nonresident alien, a taxpayer may not claim an education tax credit with respect to the qualified tuition and related expenses of the student unless the student is a claimed dependent (as defined in § 1.25A–2(a)).

§ 1.25A–2 Definitions.

(a) *Claimed dependent.* A *claimed dependent* means a dependent (as defined in section 152) for whom a deduction under section 151 is allowed on a taxpayer’s federal income tax return for the taxable year. Among other requirements under section 152, a nonresident alien student must be a resident of a country contiguous to the United States in order to be treated as a dependent.

(b) *Eligible educational institution—(1) In general.* In general, an *eligible educational institution* means a college, university, vocational school, or other postsecondary educational institution that is—

(i) Described in section 481 of the Higher Education Act of 1965 (20 U.S.C. 1088) as in effect on August 5, 1997, (generally all accredited public, nonprofit, and proprietary postsecondary institutions); and

(ii) Participating in a federal financial aid program under title IV of the Higher Education Act of 1965 or is certified by the Department of Education as eligible to participate in such a program but chooses not to participate.

(2) *Rules on federal financial aid programs.* For rules governing an educational institution’s eligibility to participate in federal financial aid programs, see 20 U.S.C. 1070; 20 U.S.C. 1094; and 34 CFR 600 and 668.

(c) *Academic period.* *Academic period* means a quarter, semester, trimester, or other period of study as reasonably determined by an eligible educational institution. In the case of an eligible educational institution that uses credit hours or clock hours, and does not have academic terms, each payment period (as defined in 34 CFR 668.4, revised as of July 1, 2002) may be treated as an academic period.

(d) *Qualified tuition and related expenses—(1) In general.* *Qualified tuition and related expenses* means tuition and fees required for the enrollment or attendance of a student for courses of instruction at an eligible educational institution.

(2) *Required fees—(i) In general.* Except as provided in paragraph (d)(3) of this

section, the test for determining whether any fee is a qualified tuition and related expense is whether the fee is required to be paid to the eligible educational institution as a condition of the student’s enrollment or attendance at the institution.

(ii) *Books, supplies, and equipment.* Qualified tuition and related expenses include fees for books, supplies, and equipment used in a course of study only if the fees must be paid to the eligible educational institution for the enrollment or attendance of the student at the institution.

(iii) *Nonacademic fees.* Except as provided in paragraph (d)(3) of this section, qualified tuition and related expenses include fees charged by an eligible educational institution that are not used directly for, or allocated to, an academic course of instruction only if the fee must be paid to the eligible educational institution for the enrollment or attendance of the student at the institution.

(3) *Personal expenses.* Qualified tuition and related expenses do not include the costs of room and board, insurance, medical expenses (including student health fees), transportation, and similar personal, living, or family expenses, regardless of whether the fee must be paid to the eligible educational institution for the enrollment or attendance of the student at the institution.

(4) *Treatment of a comprehensive or bundled fee.* If a student is required to pay a fee (such as a comprehensive fee or a bundled fee) to an eligible educational institution that combines charges for qualified tuition and related expenses with charges for personal expenses described in paragraph (d)(3) of this section, the portion of the fee that is allocable to personal expenses is not included in qualified tuition and related expenses. The determination of what portion of the fee relates to qualified tuition and related expenses and what portion relates to personal expenses must be made by the institution using a reasonable method of allocation.

(5) *Hobby courses.* Qualified tuition and related expenses do not include expenses that relate to any course of instruction or other education that involves sports, games, or hobbies, or any noncredit course, unless the course or other education is part of the student’s degree program, or in the case of the Lifetime Learning Credit, the student takes the course to acquire or im-

prove job skills.

(6) *Examples.* The following examples illustrate the rules of this paragraph (d). In each example, assume that the institution is an eligible educational institution and that all other relevant requirements to claim an education tax credit are met. The examples are as follows:

Example 1. University V offers a degree program in dentistry. In addition to tuition, all students enrolled in the program are required to pay a fee to University V for the rental of dental equipment. Because the equipment rental fee must be paid to University V for enrollment and attendance, the tuition and the equipment rental fee are qualified tuition and related expenses.

Example 2. First-year students at College W are required to obtain books and other reading materials used in its mandatory first-year curriculum. The books and other reading materials are not required to be purchased from College W and may be borrowed from other students or purchased from off-campus bookstores, as well as from College W's bookstore. College W bills students for any books and materials purchased from College W's bookstore. The fee that College W charges for the first-year books and materials purchased at its bookstore is not a qualified tuition and related expense because the books and materials are not required to be purchased from College W for enrollment or attendance at the institution.

Example 3. All students who attend College X are required to pay a separate student activity fee in addition to their tuition. The student activity fee 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 enrollment or attendance at College X. Therefore, the fee is a qualified tuition and related expense.

Example 4. The facts are the same as in *Example 3*, except that College X offers an optional athletic fee that students may pay to receive discounted tickets to sports events. The athletic fee is not required for enrollment or attendance at College X. Therefore, the fee is not a qualified tuition and related expense.

Example 5. College Y requires all students to live on campus. It charges a single comprehensive fee to cover tuition, required fees, and room and board. Based on College Y's reasonable allocation, sixty percent of the comprehensive fee is allocable to tuition and other required fees not allocable to personal expenses, and the remaining forty percent of the comprehensive fee is allocable to charges for room and board and other personal expenses. Therefore, only sixty percent of College Y's comprehensive fee is a qualified tuition and related expense.

Example 6. As a degree student at College Z, Student A is required to take a certain number of courses outside of her chosen major in Economics. To fulfill this requirement, Student A enrolls in a square dancing class offered by the Physical Education Department. Because Student A receives credit toward her degree program for the square dancing class, the tuition for the square dancing class is included in qualified tuition and related expenses.

§ 1.25A-3 Hope Scholarship Credit.

(a) *Amount of the credit*—(1) *In general.* Subject to the phaseout of the education tax credit described in § 1.25A-1(c), the Hope Scholarship Credit amount is the total of—

(i) 100 percent of the first \$1,000 of qualified tuition and related expenses paid during the taxable year for education furnished to an eligible student (as defined in paragraph (d) of this section) who is the taxpayer, the taxpayer's spouse, or any claimed dependent during any academic period beginning in the taxable year (or treated as beginning in the taxable year, see § 1.25A-5(e)(2)); plus

(ii) 50 percent of the next \$1,000 of such expenses paid with respect to that student.

(2) *Maximum credit.* For taxable years beginning before 2002, the maximum Hope Scholarship Credit allowed for each eligible student is \$1,500. For taxable years beginning after 2001, the amounts used in paragraph (a)(1) of this section to determine the maximum credit will be increased for inflation occurring after 2000 in accordance with section 1(f)(3). If any amount adjusted under this paragraph (a)(2) is not a multiple of \$100, the amount will be rounded to the next lowest multiple of \$100.

(b) *Per student credit*—(1) *In general.* A Hope Scholarship Credit may be claimed for the qualified tuition and related expenses of each eligible student (as defined in paragraph (d) of this section).

(2) *Example.* The following example illustrates the rule of this paragraph (b). In the example, assume that all the requirements to claim an education tax credit are met. The example is as follows:

Example. In 1999, Taxpayer A has two dependents, B and C, both of whom are eligible students. Taxpayer A pays \$1,600 in qualified tuition and related expenses for dependent B to attend a community college. Taxpayer A pays \$5,000 in qualified tuition and related expenses for dependent C to attend University X. Taxpayer A may claim a Hope Scholarship Credit of \$1,300 ($\$1,000 + (.50 \times \$600)$) for dependent B, and the maximum \$1,500 Hope Scholarship Credit for dependent C, for a total Hope Scholarship Credit of \$2,800.

(c) *Credit allowed for only two taxable years.* For each eligible student, the Hope Scholarship Credit may be claimed for no more than two taxable years.

(d) *Eligible student*—(1) *Eligible student defined.* For purposes of the Hope Scholarship Credit, the term *eligible stu-*

dent means a student who satisfies all of the following requirements—

(i) *Degree requirement.* For at least one academic period that begins during the taxable year, the student enrolls at an eligible educational institution in a program leading toward a postsecondary degree, certificate, or other recognized postsecondary educational credential;

(ii) *Work load requirement.* For at least one academic period that begins during the taxable year, the student enrolls for at least one-half of the normal full-time work load for the course of study the student is pursuing. The standard for what is half of the normal full-time work load is determined by each eligible educational institution. However, the standard for half-time may not be lower than the applicable standard for half-time established by the Department of Education under the Higher Education Act of 1965 and set forth in 34 CFR 674.2(b) (revised as of July 1, 2002) for a half-time undergraduate student;

(iii) *Year of study requirement.* As of the beginning of the taxable year, the student has not completed the first two years of postsecondary education at an eligible educational institution. Whether a student has completed the first two years of postsecondary education at an eligible educational institution as of the beginning of a taxable year is determined based on whether the institution in which the student is enrolled in a degree program (as described in paragraph (d)(1)(i) of this section) awards the student two years of academic credit at that institution for postsecondary course work completed by the student prior to the beginning of the taxable year. Any academic credit awarded by the eligible educational institution solely on the basis of the student's performance on proficiency examinations is disregarded in determining whether the student has completed two years of postsecondary education; and

(iv) *No felony drug conviction.* The student has not been convicted of a federal or state felony offense for possession or distribution of a controlled substance as of the end of the taxable year for which the credit is claimed.

(2) *Examples.* The following examples illustrate the rules of this paragraph (d). In each example, assume that the student has not been convicted of a felony drug offense, that the institution is an eligible educational institution unless otherwise stated,

that the qualified tuition and related expenses are paid during the same taxable year that the academic period begins, and that a Hope Scholarship Credit has not previously been claimed for the student (see paragraph (c) of this section). The examples are as follows:

Example 1. Student A graduates from high school in June 1998 and is enrolled in an undergraduate degree program at College U for the 1998 Fall semester on a full-time basis. For the 1999 Spring semester, Student A again is enrolled at College U on a full-time basis. For the 1999 Fall semester, Student A is enrolled in less than half the normal full-time course work for her degree program. Because Student A is enrolled in an undergraduate degree program on at least a half-time basis for at least one academic period that begins during 1998 and at least one academic period that begins during 1999, Student A is an eligible student for taxable years 1998 and 1999 (including the 1999 Fall semester when Student A enrolls at College U on less than a half-time basis).

Example 2. Prior to 1998, Student B attended college for several years on a full-time basis. Student B transfers to College V for the 1998 Spring semester. College V awards Student B credit for some (but not all) of the courses he previously completed, and College V classifies Student B as a first-semester sophomore. During both the Spring and Fall semesters of 1998, Student B is enrolled in at least one-half the normal full-time work load for his degree program at College V. Because College V does not classify Student B as having completed the first two years of postsecondary education as of the beginning of 1998, Student B is an eligible student for taxable year 1998.

Example 3. The facts are the same as in *Example 2*. After taking classes on a half-time basis for the 1998 Spring and Fall semesters, Student B is enrolled at College V for the 1999 Spring semester on a full-time basis. College V classifies Student B as a second-semester sophomore for the 1999 Spring semester and as a first-semester junior for the 1999 Fall semester. Because College V does not classify Student B as having completed the first two years of postsecondary education as of the beginning of 1999, Student B is an eligible student for taxable year 1999. Therefore, the qualified expenses and required fees paid for the 1999 Spring semester and the 1999 Fall semester are taken into account in calculating any Hope Scholarship Credit.

Example 4. Prior to 1998, Student C was not enrolled at another eligible educational institution. At the time that Student C enrolls in a degree program at College W for the 1998 Fall semester, Student C takes examinations to demonstrate her proficiency in several subjects. On the basis of Student C's performance on these examinations, College W classifies Student C as a second-semester sophomore as of the beginning of the 1998 Fall semester. Student C is enrolled at College W during the 1998 Fall semester and during the 1999 Spring and Fall semesters on a full-time basis and is classified as a first-semester junior as of the beginning of the 1999 Spring semester. Because Student C was not enrolled in a college or other eligible educational institution prior to 1998 (but rather was awarded three semesters of academic credit solely because of proficiency examinations), Student C is not treated as having completed the first two years of postsecondary education at an eligible educational insti-

tution as of the beginning of 1998 or as of the beginning of 1999. Therefore, Student C is an eligible student for both taxable years 1998 and 1999.

Example 5. During the 1998 Fall semester, Student D is a high school student who takes classes on a half-time basis at College X. Student D is not enrolled as part of a degree program at College X because College X does not admit students to a degree program unless the student has a high school diploma or equivalent. Because Student D is not enrolled in a degree program at College X during 1998, Student D is not an eligible student for taxable year 1998.

Example 6. The facts are the same as in *Example 5*. In addition, during the 1999 Spring semester, Student D again attends College X but not as part of a degree program. Student D graduates from high school in June 1999. For the 1999 Fall semester, Student D enrolls in College X as part of a degree program, and College X awards Student D credit for her prior course work at College X. During the 1999 Fall semester, Student D is enrolled in more than one-half the normal full-time work load of courses for her degree program at College X. Because Student D is enrolled in a degree program at College X for the 1999 Fall term on at least a half-time basis, Student D is an eligible student for all of taxable year 1999. Therefore, the qualified tuition and required fees paid for classes taken at College X during both the 1999 Spring semester (during which Student D was not enrolled in a degree program) and the 1999 Fall semester are taken into account in computing any Hope Scholarship Credit.

Example 7. Student E completed two years of undergraduate study at College S. College S is not an eligible educational institution for purposes of the education tax credit. At the end of 1998, Student E enrolls in an undergraduate degree program at College Z, an eligible educational institution, for the 1999 Spring semester on a full-time basis. College Z awards Student E two years of academic credit for his previous course work at College S and classifies Student E as a first-semester junior for the 1999 Spring semester. Student E is treated as having completed the first two years of postsecondary education at an eligible educational institution as of the beginning of 1999. Therefore, Student E is not an eligible student for taxable year 1999.

Example 8. Student F received a degree in 1998 from College R. College R is not an eligible educational institution for purposes of the education tax credit. During 1999, Student F is enrolled in a graduate-degree program at College Y, an eligible educational institution, for the 1999 Fall semester on a full-time basis. By admitting Student F to its graduate degree program, College Y treats Student F as having completed the first two years of postsecondary education as of the beginning of 1999. Therefore, Student F is not an eligible student for taxable year 1999.

Example 9. Student G graduates from high school in June 2001. In January 2002, Student G is enrolled in a one-year postsecondary certificate program on a full-time basis to obtain a certificate as a travel agent. Student G completes the program in December 2002 and is awarded a certificate. In January 2003, Student G enrolls in a one-year postsecondary certificate program on a full-time basis to obtain a certificate as a computer programmer. Student G meets the degree requirement, the work load requirement, and the year of study requirement for the

taxable years 2002 and 2003. Therefore, Student G is an eligible student for both taxable years 2002 and 2003.

(e) *Academic period for prepayments*—
(1) *In general.* For purposes of determining whether a student meets the requirements in paragraph (d) of this section for a taxable year, if qualified tuition and related expenses are paid during one taxable year for an academic period that begins during January, February or March of the next taxable year (for taxpayers on a fiscal taxable year, use the first three months of the next taxable year), the academic period is treated as beginning during the taxable year in which the payment is made.

(2) *Example.* The following example illustrates the rule of this paragraph (e). In the example, assume that all the requirements to claim a Hope Scholarship Credit are met. The example is as follows:

Example. Student G graduates from high school in June 1998. After graduation, Student G works full-time for several months to earn money for college. Student G is enrolled on a full-time basis in an undergraduate degree program at University W, an eligible educational institution, for the 1999 Spring semester, which begins in January 1999. Student G pays tuition to University W for the 1999 Spring semester in December 1998. Because the tuition paid by Student G in 1998 relates to an academic period that begins during the first three months of 1999, Student G's eligibility to claim a Hope Scholarship Credit in 1998 is determined as if the 1999 Spring semester began in 1998. Thus, assuming Student G has not been convicted of a felony drug offense as of December 31, 1998, Student G is an eligible student for 1998.

(f) *Effective date.* The Hope Scholarship Credit is applicable for qualified tuition and related expenses paid after December 31, 1997, for education furnished in academic periods beginning after December 31, 1997.

§ 1.25A-4 Lifetime Learning Credit.

(a) *Amount of the credit*—(1) *Taxable years beginning before January 1, 2003.* Subject to the phaseout of the education tax credit described in § 1.25A-1(c), for taxable years beginning before 2003, the Lifetime Learning Credit amount is 20 percent of up to \$5,000 of qualified tuition and related expenses paid during the taxable year for education furnished to the taxpayer, the taxpayer's spouse, and any claimed dependent during any academic period beginning in the taxable year (or treated as beginning in the taxable year, see § 1.25A-5(e)(2)).

(2) *Taxable years beginning after December 31, 2002.* Subject to the phaseout

of the education tax credit described in § 1.25A-1(c), for taxable years beginning after 2002, the Lifetime Learning Credit amount is 20 percent of up to \$10,000 of qualified tuition and related expenses paid during the taxable year for education furnished to the taxpayer, the taxpayer's spouse, and any claimed dependent during any academic period beginning in the taxable year (or treated as beginning in the taxable year, see § 1.25A-5(e)(2)).

(3) *Coordination with the Hope Scholarship Credit.* Expenses paid with respect to a student for whom the Hope Scholarship Credit is claimed are not eligible for the Lifetime Learning Credit.

(4) *Examples.* The following examples illustrate the rules of this paragraph (a). In each example, assume that all the requirements to claim a Lifetime Learning Credit or a Hope Scholarship Credit, as applicable, are met. The examples are as follows:

Example 1. In 1999, Taxpayer A pays qualified tuition and related expenses of \$3,000 for dependent B to attend an eligible educational institution, and Taxpayer A pays qualified tuition and related expenses of \$4,000 for dependent C to attend an eligible educational institution. Taxpayer A does not claim a Hope Scholarship Credit with respect to either B or C. Although Taxpayer A paid \$7,000 of qualified tuition and related expenses during the taxable year, Taxpayer A may claim the Lifetime Learning Credit with respect to only \$5,000 of such expenses. Therefore, the maximum Lifetime Learning Credit Taxpayer A may claim for 1999 is \$1,000 (.20 x \$5,000).

Example 2. In 1999, Taxpayer D pays \$6,000 of qualified tuition and related expenses for dependent E, and \$2,000 of qualified tuition and related expenses for dependent F, to attend eligible educational institutions. Dependent F has already completed the first two years of postsecondary education. For 1999, Taxpayer D claims the maximum \$1,500 Hope Scholarship Credit with respect to dependent E. In computing the amount of the Lifetime Learning Credit, Taxpayer D may not include any of the \$6,000 of qualified tuition and related expenses paid on behalf of dependent E but may include the \$2,000 of qualified tuition and related expenses of dependent F.

(b) *Credit allowed for unlimited number of taxable years.* There is no limit to the number of taxable years that a taxpayer may claim a Lifetime Learning Credit with respect to any student.

(c) *Both degree and nondegree courses are eligible for the credit—(1) In general.* For purposes of the Lifetime Learning Credit, amounts paid for a course at an eligible educational institution are qualified tuition and related expenses if the course is either part of a postsecondary degree program or is not part of a postsecondary degree program but is taken by the student to acquire or improve job skills.

(2) *Examples.* The following examples illustrate the rule of this paragraph (c). In each example, assume that all the requirements to claim a Lifetime Learning Credit are met. The examples are as follows:

Example 1. Taxpayer A, a professional photographer, enrolls in an advanced photography course at a local community college. Although the course is not part of a degree program, Taxpayer A enrolls in the course to improve her job skills. The course fee paid by Taxpayer A is a qualified tuition and related expense for purposes of the Lifetime Learning Credit.

Example 2. Taxpayer B, a stockbroker, plans to travel abroad on a "photo-safari" for his next vacation. In preparation for the trip, Taxpayer B enrolls in a non-credit photography class at a local community college. Because Taxpayer B is not taking the photography course as part of a degree program or to acquire or improve his job skills, amounts paid by Taxpayer B for the course are not qualified tuition and related expenses for purposes of the Lifetime Learning Credit.

(d) *Effective date.* The Lifetime Learning Credit is applicable for qualified tuition and related expenses paid after June 30, 1998, for education furnished in academic periods beginning after June 30, 1998.

§ 1.25A-5 Special rules relating to characterization and timing of payments.

(a) *Educational expenses paid by claimed dependent.* For any taxable year for which the student is a claimed dependent of another taxpayer, qualified tuition and related expenses paid by the student are treated as paid by the taxpayer to whom the deduction under section 151 is allowed.

(b) *Educational expenses paid by a third party—(1) In general.* Solely for purposes of section 25A, if a third party (someone other than the taxpayer, the taxpayer's spouse if the taxpayer is treated as married within the meaning of section 7703, or a claimed dependent) makes a payment directly to an eligible educational institution to pay for a student's qualified tuition and related expenses, the student is treated as receiving the payment from the third party and, in turn, paying the qualified tuition and related expenses to the institution.

(2) *Special rule for tuition reduction included in gross income of employee.* Solely for purposes of section 25A, if an eligible educational institution provides a reduction in tuition to an employee of the institution (or to the spouse or dependent child of an employee, as described in section 132(h)(2)) and the amount of the tuition reduction is included in the employee's gross income, the employee is treated as receiving

payment of an amount equal to the tuition reduction and, in turn, paying such amount to the institution.

(3) *Examples.* The following examples illustrate the rules of this paragraph (b). In each example, assume that all the requirements to claim an education tax credit are met. The examples are as follows:

Example 1. Grandparent D makes a direct payment to an eligible educational institution for Student E's qualified tuition and related expenses. Student E is not a claimed dependent in 1999. For purposes of claiming an education tax credit, Student E is treated as receiving the money from her grandparent and, in turn, paying her qualified tuition and related expenses.

Example 2. Under a court-approved divorce decree, Parent A is required to pay Student C's college tuition. Parent A makes a direct payment to an eligible educational institution for Student C's 1999 tuition. Under paragraph (b)(1) of this section, Student C is treated as receiving the money from Parent A and, in turn, paying the qualified tuition and related expenses. Under the divorce decree, Parent B has custody of Student C for 1999. Parent B properly claims Student C as a dependent on Parent B's 1999 federal income tax return. Under paragraph (a) of this section, expenses paid by Student C are treated as paid by Parent B. Thus, Parent B may claim an education tax credit for the qualified tuition and related expenses paid directly to the institution by Parent A.

Example 3. University A, an eligible educational institution, offers reduced tuition charges to its employees and their dependent children. F is an employee of University A. F's dependent child, G, enrolls in a graduate-level course at University A. Section 117(d) does not apply, because it is limited to tuition reductions provided for education below the graduate level. Therefore, the amount of the tuition reduction received by G is treated as additional compensation from University A to F and is included in F's gross income. For purposes of claiming a Lifetime Learning Credit, F is treated as receiving payment of an amount equal to the tuition reduction from University A and, in turn, paying such amount to University A on behalf of F's child, G.

(c) *Adjustment to qualified tuition and related expenses for certain excludable educational assistance—(1) In general.* In determining the amount of an education tax credit, qualified tuition and related expenses for any academic period must be reduced by the amount of any tax-free educational assistance allocable to such period. For this purpose, *tax-free educational assistance* means—

(i) A qualified scholarship that is excludable from income under section 117;

(ii) A veterans' or member of the armed forces' educational assistance allowance under chapter 30, 31, 32, 34, or 35 of title 38, United States Code, or under chapter 1606 of title 10, United States Code;

(iii) Employer-provided educational assistance that is excludable from income under section 127; or

(iv) Any other educational assistance that is excludable from gross income (other than as a gift, bequest, devise, or inheritance within the meaning of section 102(a)).

(2) *No adjustment for excludable educational assistance attributable to expenses paid in a prior year.* A reduction is not required under paragraph (c)(1) of this section if the amount of excludable educational assistance received during the taxable year is treated as a refund of qualified tuition and related expenses paid in a prior taxable year. See paragraph (f)(5) of this section.

(3) *Scholarships and fellowship grants.* For purposes of paragraph (c)(1)(i) of this section, a scholarship or fellowship grant is treated as a qualified scholarship excludable under section 117 except to the extent—

(i) The scholarship or fellowship grant (or any portion thereof) may be applied, by its terms, to expenses other than qualified tuition and related expenses within the meaning of section 117(b)(2) (such as room and board) and the student reports the grant (or the appropriate portion thereof) as income on the student's federal income tax return if the student is required to file a return; or

(ii) The scholarship or fellowship grant (or any portion thereof) must be applied, by its terms, to expenses other than qualified tuition and related expenses within the meaning of section 117(b)(2) (such as room and board) and the student reports the grant (or the appropriate portion thereof) as income on the student's federal income tax return if the student is required to file a return.

(4) *Examples.* The following examples illustrate the rules of this paragraph (c). In each example, assume that all the requirements to claim an education tax credit are met. The examples are as follows:

Example 1. University X charges Student A, who lives on University X's campus, \$3,000 for tuition and \$5,000 for room and board. University X awards Student A a \$2,000 scholarship. The terms of the scholarship permit it to be used to pay any of a student's costs of attendance at University X, including tuition, room and board, and other incidental expenses. University X applies the \$2,000 scholarship against Student A's \$8,000 total bill, and Student A pays the \$6,000 balance of her bill from University X with a combination of savings and amounts she earns from a summer job. University X does not require A to pay any additional fees beyond the \$3,000 in tuition in order to enroll in or attend classes. Student A does not

report any portion of the scholarship as income on her federal income tax return. Since Student A does not report the scholarship as income, the scholarship is treated under paragraph (c)(3) of this section as a qualified scholarship that is excludable under section 117. Therefore, for purposes of calculating an education tax credit, Student A is treated as having paid only \$1,000 (\$3,000 tuition - \$2,000 scholarship) in qualified tuition and related expenses to University X.

Example 2. The facts are the same as in *Example 1*, except that Student A reports the entire scholarship as income on the student's federal income tax return. Since the full amount of the scholarship may be applied to expenses other than qualified expenses (room and board) and Student A reports the scholarship as income, the exception in paragraph (c)(3) of this section applies and the scholarship is not treated as a qualified scholarship excludable under section 117. Therefore, for purposes of calculating an education tax credit, Student A is treated as having paid \$3,000 of qualified tuition and related expenses to University X.

Example 3. The facts are the same as in *Example 1*, except that the terms of the scholarship require it to be used to pay tuition. Under paragraph (c)(3) of this section, the scholarship is treated as a qualified scholarship excludable under section 117. Therefore, for purposes of calculating an education tax credit, Student A is treated as having paid only \$1,000 (\$3,000 tuition - \$2,000 scholarship) in qualified tuition and related expenses to University X.

Example 4. The facts are the same as in *Example 1*, except that the terms of the scholarship require it to be used to pay tuition or room and board charged by University X, and the scholarship amount is \$6,000. Under the terms of the scholarship, Student A may allocate the scholarship between tuition and room and board in any manner. However, because room and board totals \$5,000, that is the maximum amount that can be applied under the terms of the scholarship to expenses other than qualified expenses and at least \$1,000 of the scholarship must be applied to tuition. Therefore, the maximum amount of the exception under paragraph (c)(3) of this section is \$5,000 and at least \$1,000 is treated as a qualified scholarship excludable under section 117 (\$6,000 scholarship - \$5,000 room and board). If Student A reports \$5,000 of the scholarship as income on the student's federal income tax return, then Student A will be treated as having paid \$2,000 (\$3,000 tuition - \$1,000 qualified scholarship excludable under section 117) in qualified tuition and related expenses to University X.

Example 5. The facts are the same as in *Example 1*, except that in addition to the scholarship that University X awards to Student A, University X also provides Student A with an education loan and pays Student A for working in a work/study job in the campus dining hall. The loan is not excludable educational assistance within the meaning of paragraph (c) of this section. In addition, wages paid to a student who is performing services for the payor are neither a qualified scholarship nor otherwise excludable from gross income. Therefore, Student A is not required to reduce her qualified tuition and related expenses by the amounts she receives from the student loan or as wages from her work/study job.

Example 6. In 1999, Student B pays University Y \$1,000 in tuition for the 1999 Spring semester. University Y does not require Student B to pay any additional fees beyond the \$1,000 in tuition in order to enroll in classes. Student B is an employee of Com-

pany Z. At the end of the academic period and during the same taxable year that Student B paid tuition to University Y, Student B provides Company Z with proof that he has satisfactorily completed his courses at University Y. Pursuant to an educational assistance program described in section 127(b), Company Z reimburses Student B for all of the tuition paid to University Y. Because the reimbursement from Company Z is employer-provided educational assistance that is excludable from Student B's gross income under section 127, the reimbursement reduces Student B's qualified tuition and related expenses. Therefore, for purposes of calculating an education tax credit, Student B is treated as having paid no qualified tuition and related expenses to University Y during 1999.

Example 7. The facts are the same as in *Example 6* except that the reimbursement from Company Z is not pursuant to an educational assistance program described in section 127(b), is not otherwise excludable from Student B's gross income, and is taxed as additional compensation to Student B. Because the reimbursement is not excludable educational assistance within the meaning of paragraph (c)(1) of this section, Student B is not required to reduce his qualified tuition and related expenses by the \$1,000 reimbursement he received from his employer. Therefore, for purposes of calculating an education tax credit, Student B is treated as paying \$1,000 in qualified tuition and related expenses to University Y during 1999.

(d) *No double benefit.* Qualified tuition and related expenses do not include any expense for which a deduction is allowed under section 162, section 222, or any other provision of chapter 1 of the Internal Revenue Code.

(e) *Timing rules—(1) In general.* Except as provided in paragraph (e)(2) of this section, an education tax credit is allowed only for payments of qualified tuition and related expenses for an academic period beginning in the same taxable year as the year the payment is made. Except for certain individuals who do not use the cash receipts and disbursements method of accounting, qualified tuition and related expenses are treated as paid in the year in which the expenses are actually paid. See § 1.461-1(a)(1).

(2) *Prepayment rule—(i) In general.* If qualified tuition and related expenses are paid during one taxable year for an academic period that begins during the first three months of the taxpayer's next taxable year (*i.e.*, in January, February, or March of the next taxable year for calendar year taxpayers), an education tax credit is allowed with respect to the qualified tuition and related expenses only in the taxable year in which the expenses are paid.

(ii) *Example.* The following example illustrates the rule of this paragraph (e)(2). In the example, assume that all the re-

requirements to claim an education tax credit are met. The example is as follows:

Example. In December 1998, Taxpayer A, a calendar year taxpayer, pays College Z \$1,000 in qualified tuition and related expenses to attend classes during the 1999 Spring semester, which begins in January 1999. Taxpayer A may claim an education tax credit only in 1998 for payments made in 1998 for the 1999 Spring semester.

(3) *Expenses paid with loan proceeds.* An education tax credit may be claimed for qualified tuition and related expenses paid with the proceeds of a loan only in the taxable year in which the expenses are paid, and may not be claimed in the taxable year in which the loan is repaid. Loan proceeds disbursed directly to an eligible educational institution will be treated as paid on the date the institution 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, loan proceeds will be treated as paid on the date of disbursement (as defined in 34 CFR 668.164(a), revised as of July 1, 2002) by the eligible educational institution. If a taxpayer does not know the date the institution credits the student's account, the taxpayer must treat the qualified tuition and related expenses as paid on the last date for payment prescribed by the institution.

(4) *Expenses paid through third party installment payment plans—(i) In general.* A taxpayer, an eligible educational institution, and a third party installment payment company may enter into an agreement in which the company agrees to collect installment payments of qualified tuition and related expenses from the taxpayer and to remit the installment payments to the institution. If the third party installment payment company is the taxpayer's agent for purposes of paying qualified tuition and related expenses to the eligible educational institution, the taxpayer is treated as paying the qualified expenses on the date the company pays the institution. However, if the third party installment payment company is the eligible educational institution's agent for purposes of collecting payments of qualified tuition and related expenses from the taxpayer, the taxpayer is treated as paying the qualified expenses on the date the taxpayer pays the company.

(ii) *Example.* The following example illustrates the rule of this paragraph (e)(4). The example is as follows:

Example. Student A, Company B, and College C enter into a written agreement in which Student A agrees to pay the tuition required to attend College C in 10 equal monthly installments to Company B. Under the written agreement, Student A is not relieved of her obligation to pay College C until Company B remits the payments to College C. Under the written agreement, Company B agrees to disburse the monthly installment payments to College C within 30 days of receipt. Because Company B acts as Student A's agent for purposes of paying qualified expenses to College C, Student A is treated as paying qualified expenses on the date Company B disburses payments to College C.

(f) *Refund of qualified tuition and related expenses—(1) Payment and refund of qualified tuition and related expenses in the same taxable year.* With respect to any student, the amount of qualified tuition and related expenses for a taxable year is calculated by adding all qualified tuition and related expenses paid for the taxable year, and subtracting any refund of such expenses received from the eligible educational institution during the same taxable year (including refunds of loan proceeds described in paragraph (f)(4) of this section).

(2) *Payment of qualified tuition and related expenses in one taxable year and refund in subsequent taxable year before return filed for prior taxable year.* If, in a taxable year, a taxpayer or someone other than the taxpayer receives a refund (including refunds of loan proceeds described in paragraph (f)(4) of this section) of qualified tuition and related expenses paid on behalf of a student in a prior taxable year and the refund is received before the taxpayer files a federal income tax return for the prior taxable year, the amount of the qualified tuition and related expenses for the prior taxable year is reduced by the amount of the refund.

(3) *Payment of qualified tuition and related expenses in one taxable year and refund in subsequent taxable year—(i) In general.* If, in a taxable year (refund year), a taxpayer or someone other than the taxpayer receives a refund (including refunds of loan proceeds described in paragraph (f)(4) of this section) of qualified tuition and related expenses paid on behalf of a student for which the taxpayer claimed an education tax credit in a prior taxable year, the tax imposed by chapter 1 of the Internal Revenue Code for the refund year is increased by the recapture amount.

(ii) *Recapture amount.* The recapture amount is the difference in tax liability for the prior taxable year (taking into account

any redetermination of such tax liability by audit or amended return) that results when the tax liability for the prior year is calculated using the taxpayer's redetermined credit. The redetermined credit is computed by reducing the amount of the qualified tuition and related expenses taken into account in determining any credit claimed in the prior taxable year by the amount of the refund of the qualified tuition and related expenses (redetermined qualified expenses), and computing the allowable credit using the redetermined qualified expenses and the relevant facts and circumstances of the prior taxable year, such as modified adjusted gross income (redetermined credit).

(4) *Refund of loan proceeds treated as refund of qualified tuition and related expenses.* If loan proceeds used to pay qualified tuition and related expenses (as described in paragraph (e)(3) of this section) during a taxable year are refunded by an eligible educational institution to a lender on behalf of the borrower, the refund is treated as a refund of qualified tuition and related expenses for purposes of paragraphs (f)(1), (2), and (3) of this section.

(5) *Excludable educational assistance received in a subsequent taxable year treated as a refund.* If, in a taxable year, a taxpayer or someone other than the taxpayer receives any excludable educational assistance (described in paragraph (c)(1) of this section) for the qualified tuition and related expenses paid on behalf of a student during a prior taxable year (or attributable to enrollment at an eligible educational institution during a prior taxable year), the educational assistance is treated as a refund of qualified tuition and related expenses for purposes of paragraphs (f)(2) and (3) of this section. If the excludable educational assistance is received before the taxpayer files a federal income tax return for the prior taxable year, the amount of the qualified tuition and related expenses for the prior taxable year is reduced by the amount of the excludable educational assistance as provided in paragraph (f)(2) of this section. If the excludable educational assistance is received after the taxpayer has filed a federal income tax return for the prior taxable year, any education tax credit claimed for the prior taxable year is subject to recapture as provided in paragraph (f)(3) of this section.

(6) *Examples.* The following examples illustrate the rules of this paragraph (f). In

each example, assume that all the requirements to claim an education tax credit are met. The examples are as follows:

Example 1. In January 1998, Student A, a full-time freshman at University X, pays \$2,000 for qualified tuition and related expenses for a 16-hour work load for the 1998 Spring semester. Prior to beginning classes, Student A withdraws from 6 course hours. On February 15, 1998, Student A receives a \$750 refund from University X. In September 1998, Student A pays University X \$1,000 to enroll half-time for the 1998 Fall semester. Prior to beginning classes, Student A withdraws from a 2-hour course, and she receives a \$250 refund in October 1998. Student A computes the amount of qualified tuition and related expenses she may claim for 1998 by:

(i) Adding all qualified expenses paid during the taxable year ($\$2,000 + \$1,000 = \$3,000$);

(ii) Adding all refunds of qualified tuition and related expenses received during the taxable year ($\$750 + \$250 = \$1,000$); and, then

(iii) Subtracting paragraph (ii) of this *Example 1* from paragraph (i) of this *Example 1* ($\$3,000 - \$1,000 = \$2,000$). Therefore, Student A's qualified tuition and related expenses for 1998 are \$2,000.

Example 2. (i) In December 1998, Student B, a senior at College Y, pays \$2,000 for qualified tuition and related expenses for a 16-hour work load for the 1999 Spring semester. Prior to beginning classes, Student B withdraws from a 4-hour course. On January 15, 1999, Student B files her 1998 income tax return and

claims a \$400 Lifetime Learning Credit for the \$2,000 qualified expenses paid in 1998, which reduces her tax liability for 1998 by \$400. On February 15, 1999, Student B receives a \$500 refund from College Y.

(ii) Student B calculates the increase in tax for 1999 by—

(A) Calculating the redetermined qualified expenses for 1998 ($\$2,000 - \$500 = \$1,500$);

(B) Calculating the redetermined credit for the redetermined qualified expenses ($\$1,500 \times .20 = \300); and

(C) Calculating the difference in tax liability for 1998 resulting from the redetermined credit. Because Student B's tax liability for 1998 was reduced by the full amount of the \$400 education tax credit claimed on her 1998 income tax return, the difference in tax liability can be determined by subtracting the redetermined credit from the credit claimed in 1998 ($\$400 - \$300 = \$100$).

(iii) Therefore, Student B must increase the tax on her 1999 federal income tax return by \$100.

Example 3. In September 1998, Student C pays College Z \$1,200 in qualified tuition and related expenses to attend evening classes during the 1998 Fall semester. Student C is an employee of Company R. On January 15, 1999, Student C files a federal income tax return for 1998 claiming a Lifetime Learning Credit of \$240 ($.20 \times \$1,200$), which reduces Student C's tax liability for 1998 by \$240. Pursuant to an educational assistance program described in section 127(b), Company R reimburses Student C in Feb-

ruary 1999 for the \$1,200 of qualified tuition and related expenses paid by Student C in 1998. The \$240 education tax credit claimed by Student C for 1998 is subject to recapture. Because Student C paid no net qualified tuition and related expenses for 1998, the redetermined credit for 1998 is zero. Student C must increase the amount of Student C's 1999 tax by the recapture amount, which is \$240 (the difference in tax liability for 1998 resulting from the redetermined credit for 1998 (\$0)). Because the \$1,200 reimbursement relates to expenses for which the taxpayer claimed an education tax credit in a prior year, the reimbursement does not reduce the amount of any qualified tuition and related expenses that Student C paid in 1999.

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 3. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 4. In section 602.101, paragraph (b) is revised by adding the following entry in numerical order to the table:

§ 602.101 *OMB Control numbers.*

* * * * *

(b) * * *

CFR part or section where identified and described

Current OMB control No.

* * * * *

1.25A-1 1545-1630

* * * * *

Robert E. Wenzel,
*Deputy Commissioner
of Internal Revenue.*

Approved December 13, 2002.

Pamela F. Olson,
Assistant Secretary of the Treasury.