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Reg. Section 1.25A-5(e)

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 Company 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 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 February 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.