



Fact Sheet: Interaction of Pell Grants and Tax Credits: Students May Be Foregoing Tax Benefits by Mistake

For students with scholarships, such as Pell Grants, the process for claiming education-related tax credits, like the American Opportunity Tax Credit (AOTC), is unusually complex and results in many eligible students and parents (if the student is a dependent) foregoing tax credits for which they qualify. The magnitude of the problem appears to be large—the complexity affects at least the almost 9 million students who receive Pell Grants and results in hundreds of millions of dollars of unclaimed credits each year.

Under current law, a student may choose whether to allocate his Pell Grant (and many other scholarships) to tuition, fees, and course related materials or to living expenses when filing a tax return. This choice is important because if the student allocates his Pell Grant or other scholarships to tuition and fees, the scholarship reduces the amount of expenses eligible to be used to claim education-related tax credits. If allocated to living expenses, however, then the scholarship becomes taxable for the student. (Students have this choice regardless of how the school applies the scholarship.) Maximizing the total value of scholarships and tax benefits can therefore require complicated calculations of the value of the credit (to the student *or* to the parent, if applicable) relative to the tax liability resulting from counting the scholarship as income. Students may not understand that they have this option, and many would benefit from better guidance in their decision making.

While eliminating this source of complexity would require legislation, the dissemination of accurate and clear information to students, taxpayers, colleges and universities, tax preparers, tax software providers, and other stakeholders can help students and their families to receive the education tax benefits for which they are eligible.

Current Law: The AOTC is a tax credit generally available to students in the first four years of postsecondary education to offset costs for “qualified tuition and related expenses” (QTRE), which includes tuition, required fees, and course materials. The AOTC provides a 100 percent credit for the first \$2,000 of QTRE and a 25 percent credit for the next \$2,000, for a total credit of up to \$2,500. Forty percent of the otherwise allowable AOTC, up to \$1,000, is refundable. In addition, students who are not eligible for the AOTC may be eligible for a Lifetime Learning Credit (LLC) in any year of postsecondary study. The non-refundable LLC is equal to 20 percent

of up to \$10,000 of qualifying expenses per tax return. Pell Grants (and many other scholarships) can be treated in one of two ways for tax purposes:

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

Current law generally allows students to decide whether to treat their Pell Grants as paying for QTRE or for living expenses. Notably, a student may choose to treat her Pell Grant as paying for living expenses even if the institution applies the Pell Grant against tuition and fees. A student may allocate Pell Grant funds toward living expenses up to the amount of her actual living expenses, which may differ from the living expenses estimated by her school in computing her official cost of attendance under student aid rules. The federal tax requirements applicable to this allocation decision are that 1) any scholarship (including a Pell Grant) be used in a manner consistent with its terms, 2) any scholarship that is allocated to QTRE be subtracted from QTRE for purposes of the AOTC (or LLC), and 3) any scholarship that is allocated to living expenses be included in taxable income on the student's (and not the parent's) federal income tax return.

The Issue: Many students would benefit by claiming at least a portion of their QTRE for the AOTC, even if that requires including some of their Pell Grant (or other scholarships) in taxable income (see examples below). If a student's QTRE exceeds his scholarships by \$4,000 or more, the student can claim the maximum AOTC without having to include any scholarship in income. But if QTRE minus scholarships is less than \$4,000, the student may benefit by including a portion of the scholarship in income in order to claim a larger AOTC. Most Pell Grant recipients who are eligible for the AOTC would benefit from allocating a portion their Pell Grant to living expenses so as to be able to claim at least \$2,000 of QTRE for the AOTC.

However, the tax-minimizing allocation of Pell Grants and other scholarships between QTRE and living expenses depends on a number of factors, including the terms of each scholarship, the amount of scholarships and expenses, the student's marginal tax rate and income tax available for use against the non-refundable share of AOTC or LLC, and, in the case of tax dependents, the parents' income tax before AOTC or LLC. The calculation of the optimal strategy is especially complicated because in the case of a dependent student it may depend on two tax returns and because a student's marginal tax rate may change depending on how much of the scholarship is included in income. The optimal strategy is specific to each student's situation.

Taxpayers may be unaware that they have a choice of how to allocate scholarship funds between QTRE and living expenses on their tax return. However, IRS regulations provide that the student may treat scholarship funds to have been used for non-QTRE such as room and board, simply by

including the funds in income, as long as the scholarship is allowed to be used for non-QTRE expenses, as is the case with Pell Grants. (See section 1.25A-5(c) of the regulations.)

How You Can Help: You can inform students that they have a choice in how to allocate Pell Grants for tax purposes. Information available to guide taxpayers can currently be found on page 14 of [Publication 970](#). In addition, the Tip Box on Form 8863 (used to claim credits) now explains that taxpayers may be able to reduce their tax liability if they include some of their scholarships in income. The IRS is also planning to provide Q's and A's on this topic on their webpage.

Example 1: Families that Misallocate their Expenses May Forego Tax Benefits¹

The family has earned income of \$22,000 (\$20,000 earned by the taxpayer, and \$2,000 by a dependent student). The family has \$4,000 of QTRE and receives the maximum Pell Grant of \$5,645. The student has living expenses in excess of \$5,645. For this family, total benefits are maximized if they allocate \$4,000 of their Pell Grant to living expenses, so that they can claim the maximum AOTC. If the family paid the entire tuition with the Pell Grant, the family would not be eligible for any AOTC. If the family puts the entire Pell Grant toward living expenses, the family's tax refund is maximized, even though the total amount of tax before considering the AOTC is higher.

Column 1: This family allocates the Pell Grant to the first \$5,645 of the student's living expenses. This leaves \$4,000 of tuition expenses available for an AOTC of \$1,300. The student's tax liability is \$145 after including the Pell Grant in income. Altogether, the family's total tax liability is reduced by \$1,155

Column 2: This family allocates the Pell Grant to all \$4,000 of tuition, leaving no expenses eligible for the AOTC, and thus, receives no education credit. While the student has \$0 in tax liability, the family forfeits \$1,155 in benefits.

	Scholarship Used to Pay Living Expenses	Scholarship Used to Pay Tuition, Fees, and Books
Total Pell Grants	5,645	5,645
Pell Used to Pay Tuition, Required Fees and Books	0	4,000
Pell Used to Pay Living Expenses	5,645	1,645
Expenses Eligible for AOTC (up to \$4,000)	4,000	0
Total Income Parent	20,000	20,000
Taxable Income	3,000	3,000
Tax Before Credits	300	300
AOTC	1,300	0
EITC	2,958	2,958
Tax Liability of Parent ¹	-3,958	-2,658
Total Income Student	7,645	3,645
Taxable Income	1,445	0
Tax Liability of Student	145	0
Total Tax Liability of Family	-3,813	-2,658
Net Loss from Failing to Optimize Benefits ²		1,155

¹ Negative values indicate that the family is receiving a refund.

² The net loss from failing to optimize benefits equals the value of the foregone AOTC minus the tax the student avoids by using the Pell for tuition and excluding it from income.

¹ All calculations in Example 1 and Example 2 use parameters for 2014. Due to rounding rules, amounts presented here may differ slightly from amounts based on the tax tables the IRS will produce for the filing season.

Example 2: Maximizing Total Tax Benefits May Mean Foregoing Some AOTC

This family consists of a parent who attends school full time while raising a dependent child eligible for the EITC. The parent has earned income of \$20,000. She has \$4,000 of QTRE and receives the maximum Pell Grant of \$5,645. Her living expenses are in excess of \$5,645. For this family, total benefits are maximized if the taxpayer allocates \$2,000 of her Pell Grant to QTRE living expenses, so that she can claim \$2,000 in expenses to qualify for the AOTC. If the family paid the entire tuition with the Pell Grant, the family would not be eligible for any AOTC. If the family put the entire Pell Grant toward living expenses, AOTC would be maximized, but tax after credits would increase.

Column 1: The family applies the Pell Grant to pay the first \$3,645 of the student's living expenses. This leaves \$2,000 of tuition expenses available for an AOTC of \$1,465 and an EITC of \$2,376.

Column 2: The family applies the Pell Grant to all \$4,000 of tuition, leaving no expenses eligible for the AOTC. This family receives no AOTC and an EITC of \$2,695. Relative to the optimum split, this family leaves \$946 on the table.

	Scholarship Partially Used to Pay Living Expenses	Scholarship Used to Pay Tuition, Fees, and Books
Total Pell Grants	5,645	5,645
Pell Used to Pay Tuition, Required Fees and Books	2,000	4,000
Pell Used to Pay Living Expenses	3,645	1,645
Expenses Eligible for AOTC (up to \$4,000)	2,000	0
Total Income Student/Taxpayer	23,645	21,645
Taxable Income	6,645	4,645
Tax Before Credits	665	465
AOTC	1,465	0
EITC	2,376	2,695
Tax Liability of Student/Taxpayer ¹	-3,176	-2,231
Net Loss from Failing to Optimize Benefits ²		946

¹ Negative values indicate that the family is receiving a refund. Tax liability includes the EITC, which varies with income. We have assumed the dependent does not qualify for the child credit because the child credit is not affected in this example.

² The net loss from failing to optimize benefits equals the value of the foregone AOTC minus the tax the student avoids by using the Pell for tuition and excluding it from income minus the value of the increase in the EITC from excluding the Pell from income.