[4830-01-u]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG-106388-98]

RIN 1545-AW65

Education Tax Credits

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and requests to hold a videoconference public hearing.

SUMMARY: This document contains proposed regulations relating to the Hope Scholarship Credit and the Lifetime Learning Credit in section 25A of the Internal Revenue Code. These proposed regulations provide guidance to individuals who may claim the Hope Scholarship Credit or the Lifetime Learning Credit for certain postsecondary educational expenses. This document also announces that a public hearing will be held on the proposed regulations upon request and that persons outside the Washington, DC, area who wish to testify at the hearing may request that the IRS videoconference the hearing to their sites.

DATES: Written or electronically generated comments must be received by April 6, 1999. Requests to videoconference the hearing to other sites must be received by March 8, 1999.

ADDRESSES: Send submissions to: CC:DOM:CORP:R (REG-106388-98), room 5226, Internal Revenue Service,

POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:R (REG-106388-98), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue., NW., Washington, DC. Alternatively, taxpayers may submit comments electronically via the internet by selecting the "Tax Regs" option on the IRS Home Page, or by submitting comments directly to the IRS internet site at http://www.irs.ustreas.gov/prod/tax_regs/comments.html. The IRS will publish the time and date of the public hearing and the locations of any videoconferencing sites in the **Federal Register**.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Donna Welch, (202) 622-4910; concerning submissions of comments, the hearing, and/or to be placed on the building access list to attend the hearing, contact Michael L. Slaughter, (202) 622-7190 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in this notice of proposed rulemaking has been submitted to the Office of Management and Budget for review in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)). Comments on the collection of information should be sent to the **Office of Management and Budget**, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the **Internal Revenue**

Service, Attn: IRS Reports Clearance Officer, OP:FS:FP, Washington, DC 20224. Comments on the collection of information should be received by March 8, 1999. Comments are specifically requested concerning:

Whether the proposed collection of information is necessary for the proper performance of the functions of the Internal Revenue Service, including whether the information will have practical utility;

The accuracy of the estimated burden associated with the proposed collection of information (see below);

How the quality, utility, and clarity of the information to be collected may be enhanced;

How the burden of complying with the proposed collection of information may be minimized, including through the application of automated collection techniques or other forms of information technology; and

Estimates of capital or start-up costs and costs of operation, maintenance, and purchase of services to provide information.

The collection of information in this proposed regulation 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 timely filed (including extensions) 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 assigned by the Office of Management and Budget.

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

The Taxpayer Relief Act of 1997 (Public Law 105-34 (111 Stat. 788) (TRA '97)) added section 25A to the Internal Revenue Code to provide the Hope Scholarship Credit and the Lifetime Learning Credit (education credits). In general, the Hope Scholarship Credit and the Lifetime Learning Credit allow taxpayers to claim a nonrefundable credit against their federal income taxes for certain postsecondary educational expenses. On November 17, 1997, the IRS published Notice 97-60 (1997-46 I.R.B. 8) to provide general guidance on the higher education tax incentives enacted by TRA '97, including the Hope Scholarship

Credit and the Lifetime Learning Credit. This document contains proposed amendments to the Income Tax Regulations (26 CFR part 1) to provide detailed guidance on the education credits in section 25A.

TRA '97 also added section 6050S to the Code, which requires eligible educational institutions to file information returns to assist taxpayer and the IRS in determining the education credit that taxpayers may claim under section 25A. The IRS has published several notices outlining the limited information returns that are required for 1998 and 1999. On December 22, 1997, the IRS published Notice 97-73 (1997-51 I.R.B. 16), which describes the information that must be reported for 1998. On September 8, 1998, the IRS published Notice 98-46 (1998-36 I.R.B. 21), which extends the application of Notice 97-73 to information returns required under section 6050S for 1999. Finally, on December 7, 1998, the IRS published Notice 98-59 (1998-49 I.R.B. 16), which modified the two prior Notices by providing that an eligible educational institution is not required to file information returns under section 6050S for 1998 or 1999 with respect to either: (1) students who are enrolled during the year only in courses for which the student receives no academic credit from the educational institution; or (2) nonresident alien students, unless requested to do so by the student. The IRS and the Treasury Department intend to issue separate regulations on the information reporting required under section 6050S for years after 1999.

Explanation of Provisions

1. Calculation of Education Credit and General Eligibility Requirements

Under the proposed regulations, a taxpayer may claim a nonrefundable education credit equal to the total of the Hope Scholarship Credit and the Lifetime Learning Credit allowed for the taxpayer, the taxpayer's spouse, and any claimed dependents. An education credit in excess of a taxpayer's tax liability for the taxable year can not be refunded. As with other personal credits, section 25A does not allow a carryforward of an unused education credit or a carryforward of excess qualified expenses.

The proposed regulations provide rules for the coordination of the Hope Scholarship Credit and the Lifetime Learning Credit. The proposed regulations provide that, in the same taxable year, a taxpayer may claim a Hope Scholarship Credit for each eligible student's qualified tuition and related expenses and a Lifetime Learning Credit for one or more other students' qualified tuition and related expenses. The regulations provide that a taxpayer may claim either the Hope Scholarship Credit or the Lifetime Learning Credit, but not both, for the qualified tuition and related expenses of the same student in the same taxable year. A Hope Scholarship Credit may be claimed for the qualified tuition and related expenses (up to a specified limit described below) of each eligible student. The Lifetime Learning Credit may be claimed for the aggregate amount of qualified tuition and related expenses (up to a specified limit described below) of those students for whom no Hope Scholarship Credit is claimed.

Consistent with the income limitations in section 25A(d), the proposed regulations provide that the education credit allowed is phased out for taxpayers with modified adjusted gross income between $40,000 and $50,000 ($80,000 and $100,000 for taxpayers filing a joint return) for the taxable year. For taxable years beginning after 2001, these amounts will be adjusted for inflation. Based on the definition in section 25A(d)(3), the regulations define modified adjusted gross income as 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). The amount of an otherwise allowable education credit for a taxable year that is reduced solely by reason of the modified adjusted gross income limitation can not be carried forward and claimed in a subsequent taxable year.

Consistent with the requirements in section 25A(e)(1), the proposed regulations provide that a taxpayer must elect to claim the education credit. The election must be made by attaching Form 8863, "Education Credits (Hope and Lifetime Learning Credits)," to the taxpayer's federal income tax return for the taxable year in which the credit is claimed. Consistent with the identification requirements in section 25A(g)(1), the regulations provide that a taxpayer must include on the federal income tax return the name and taxpayer identification number of each student for whom the credit is claimed.

Consistent with the requirements in section 25A(e)(2), the proposed regulations provide that no education credit is allowed for a taxable year for the qualified tuition and related expenses of a student if: (1) during the taxable year, a distribution is made to, or on behalf of, the student from an education individual retirement account described in section 530(b); and (2) any portion of the distribution is excluded from gross income under section 530(d)(2).

The proposed regulations provide guidance on the rules for claiming an education credit in the case of a dependent. The regulations provide that, if the student is a claimed dependent of another taxpayer, only that taxpayer may claim the education credit for the student's qualified tuition and related expenses. The regulations explain that, if the taxpayer is eligible to, but does not, claim the student as a dependent, only the student may claim the education credit for the student's qualified tuition and related expenses.

2. Definitions

The proposed regulations provide that a claimed dependent is a dependent (as defined in section 152) for whom a deduction under section 151 is allowed on the taxpayer's federal income tax return for the taxable year in which the credit is claimed.

Based on the requirements of section 25A(f)(2), the proposed regulations provide that an eligible educational institution means a college, university, vocational school, or other postsecondary educational institution that: (1) is described in

section 481 of the Higher Education Act of 1965 (HEA) (20 U.S.C. 1088) as in effect on August 5, 1997 (generally all accredited public, nonprofit, and proprietary postsecondary institutions); and (2) participates in a federal student financial aid program under title IV of the HEA (20 U.S.C. 1070 et seq.) or is certified by the Department of Education as eligible to participate in such a program but chooses not to participate.

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. Neither section 25A nor its legislative history defines the term academic period. Additionally, the Department of Education does not have a recognized definition of academic period. The definition in the regulation 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 Treasury invite comments on this definition of academic period as well as suggestions on alternative definitions.

Based on the definition in section 25A(f)(1), the proposed regulations define qualified tuition and related expenses as the tuition and fees required for the enrollment or attendance of a student for courses of instruction at an eligible educational institution. This definition is generally consistent with the definition of tuition and fees contained in section 472(1) of the HEA (20 U.S.C. 1087ll(1)). See H.R. Conf. Rep. No. 599, 105th

Cong., 2d Sess., at p. 321 (1998). The regulations provide that, in general, the test for determining whether a fee is treated as a qualified tuition and related expense is whether the fee is required to be paid to the eligible educational institution by students as a condition of the students' enrollment or attendance at the institution. The regulations specifically provide that 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. Similarly, the regulations provide that, in general, qualified tuition and related expenses include nonacademic fees (fees charged by an eligible educational institution that are not used directly for, or allocated to, an academic 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.

However, based on the legislative history to section 25A, the proposed regulations provide that qualified tuition and related expenses do not include the costs of room and board, insurance, medical expenses (such as student health fees), transportation, and similar personal, living, or family expenses, regardless of whether the fees must be paid to the eligible educational institution for the enrollment or attendance of the student at the institution. See H.R. Conf. Rep. No. 220, 105th Cong., 1st Sess., at p. 343, 346 (1997). Further, based on the

limitations in section 25A(f)(1)(B) and (c)(2)(B), the regulations provide that qualified tuition and related expenses do not include expenses that relate to any course of instruction or other education that involves sports, games, hobbies, or any noncredit course, unless the course is part of the student's degree program or, in the case of the Lifetime Learning Credit, is taken by the student to acquire or improve job skills.

3. Hope Scholarship Credit

The Hope Scholarship Credit is a per student credit that may be claimed for each eligible student. Consistent with the provisions of section 25A(b)(1), the proposed regulations provide that for taxable years beginning before 2002 the maximum Hope Scholarship Credit amount is $1,500 (100 percent of the first $1,000 of the qualified tuition and related expenses paid during the taxable year for education furnished to an eligible student during any academic period beginning in the taxable year or treated as beginning in the taxable year, plus 50 percent of the next $1,000 of such expenses paid with respect to that student). For taxable years beginning after 2001, the $1,000 amounts will be adjusted for inflation. Consistent with the provisions of section 25A(b)(2)(A), the regulations provide that the Hope Scholarship Credit is allowed for only two taxable years for each eligible student.

Based on the requirements in section 25A(b)(2) and (3), the proposed regulations define an eligible student for purposes of the Hope Scholarship Credit as a student who meets all of the

following requirements: (1) for at least one academic period 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 (degree requirement); (2) for at least one academic period during the taxable year, the student enrolls for at least half of the normal full-time work load for the course of study the student is pursuing (work load requirement); (3) 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 (year of study requirement); and (4) the student has not been convicted of a federal or state felony offense for the possession or distribution of a controlled substance as of the end of the taxable for which the credit is claimed (felony drug conviction restriction).

The proposed regulations explain that the student meets the work load requirement if the student is enrolled for at least half of the normal full-time work load, as determined by the eligible educational institution. The regulations provide that the educational institution's standards for a half-time work load must equal or exceed the standards established by the Department of Education under the HEA and set forth in 34 CFR 674.2(b) for a half-time undergraduate student.

The proposed regulations explain that whether a student has completed the first two years of postsecondary education as of

the beginning of the taxable year is based on whether the eligible educational institution the student is enrolled in awards the student two years of academic credit for postsecondary course work completed by the student prior to the beginning of the taxable year. However, the regulations provide that any academic credit awarded by the educational institution solely on the basis of the student's performance on proficiency examinations is not taken into account.

The proposed regulations provide that the Hope Scholarship Credit is effective for expenses paid after December 31, 1997, for education furnished in academic periods beginning after that date.

4. Lifetime Learning Credit

The Lifetime Learning Credit is a per taxpayer credit, rather than a per student credit. For taxable years beginning before 2003, the maximum Lifetime Learning Credit amount is $1,000 (20 percent of up to $5,000 of the aggregate 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). For taxable years beginning on or after 2003, the maximum credit amount is $2,000 (20 percent of up to $10,000 of the aggregate 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).

In contrast to the Hope Scholarship Credit, the Lifetime Learning Credit is allowed for an unlimited number of years for each student and does not have a degree requirement, year of study requirement, work load requirement, or a felony drug conviction restriction. See H.R. Conf. Rep. No. 220, 105th Cong., 1st Sess., at p. 346-347 (1997). Therefore, a taxpayer may claim a Lifetime Learning Credit for a student's qualified tuition and related expenses even if the taxpayer could not claim a Hope Scholarship Credit for those expenses.

Based on the provisions of section 25A(c)(2)(B) and the legislative history to section 25A, the proposed regulations provide that, for purposes of claiming a Lifetime Learning Credit, amounts that a taxpayer is required to pay 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 part of a nondegree program that is taken by the student to acquire or improve job skills. The legislative history explains that the Lifetime Learning Credit is available with respect to any course of instruction at any eligible educational institution (whether the student is enrolled on a full-time, half-time, or less than half-time basis) to acquire or improve job skills of the student. See H.R. Conf. Rep. No. 220, 105th Cong., 1st Sess., at p. 346-347 (1997).

The proposed regulations provide that the Lifetime Learning

Credit is effective for expenses paid after June 30, 1998, for education furnished in academic periods beginning after that date.

5. Special Rules Relating to Characterization and Timing of Payments

The proposed regulations provide guidance on qualified tuition and related expenses paid by a third party. The regulations provide that, solely for purposes of section 25A, if a third party 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.

Consistent with the provisions of section 25A(g)(3), the proposed regulations provide that qualified tuition and related expenses paid by a student are treated as paid by the taxpayer if the student is a claimed dependent of the taxpayer.

The proposed regulations provide rules for adjustments to qualified tuition and related expenses for certain excludable educational assistance. Consistent with the provisions of section 25A(g)(2) and the legislative history, the regulations provide that the amount of otherwise allowable qualified tuition and related expenses paid during a taxable year must be reduced by the following amounts paid to, or on behalf of, a student during the taxable year: (1) a qualified scholarship that is excludable from gross income under section 117; (2) a veterans' or member of the armed forces' educational assistance allowance

under chapter 30, 31, 32, 34, or 35 of title 38, U.S.C., or chapter 1606 of title 10, U.S.C.; (3) employer-provided educational assistance that is excludable from gross income under section 127; and (4) 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)). See H.R. Conf. Rep. No. 220, 105th Cong., 1st Sess., at p. 343, 347 (1997).

The proposed regulations provide rules for allocating scholarships and fellowship grants among expenses. The regulations provide that a scholarship or fellowship grant is treated as a qualified scholarship excludable from income under section 117 (and thereby reduces the amount of qualified tuition and related expenses that a taxpayer may otherwise include in claiming an education credit) unless either: (1) the student reports the grant as income on the student's federal income tax return; or (2) the grant 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.

The proposed regulations provide guidance on the timing rules for claiming an education credit. Consistent with the general rule in section 25A(b)(1) and (c)(1), the regulations provide that an education credit generally is allowed only for payments of qualified tuition and related expenses that cover an academic period beginning in the same taxable year as the year the payment is made. However, consistent with the specific

prepayment rule in section 25A(g)(4), the regulations provide that, if qualified tuition and related expenses are paid during a taxable year to cover an academic period that begins during the first three months of the taxpayer's next taxable year, an education credit is allowed only in the taxable year in which the expenses are paid. Note, however, that because the Hope Scholarship Credit does not apply to expenses paid before January 1, 1998, and the Lifetime Learning Credit does not apply to expenses paid before July 1, 1998, the prepayment rule does not apply for tuition paid in 1997 to cover an academic period beginning in 1998.

Consistent with the legislative history to section 25A, the proposed regulations provide that an education credit may be claimed for the qualified tuition and related expenses paid with the proceeds of a loan only in the taxable year in which the expenses are paid, and not in the taxable year in which the loan is repaid. See H.R. Conf. Rep. No. 220, 105th Cong., 1st Sess., at p. 342, 346 (1997). In order to provide taxpayers with a date certain for payment, the regulations provide that loan proceeds disbursed directly to an educational institution are treated as paid on the date of the disbursement. However, if the taxpayer does not know the date of the disbursement, the taxpayer must treat qualified tuition and related expenses as paid on the last date prescribed for payment by the educational institution.

Consistent with the directive in section 25A(i), the proposed regulations provide rules for refunds of qualified

tuition and related expenses. The regulations provide that, if a payment and a refund of qualified tuition and related expenses occur in the same taxable year, the amount of qualified tuition and related expenses for the taxable year is calculated by adding all qualified tuition and related expenses paid for the taxable year, and subtracting any refund of the expenses received from the eligible educational institution during the same taxable year.

The proposed regulations provide that, if, in a taxable year, a taxpayer (or the taxpayer's spouse or a claimed dependent) receives a refund from an eligible educational institution of qualified tuition and related expenses paid 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 must be reduced by the amount of the refund.

Similar to the tax benefit rule, the proposed regulations provide that, if, in a taxable year, a taxpayer (or the taxpayer's spouse or a claimed dependent) receives a refund of qualified tuition and related expenses for which the taxpayer claimed an education credit in a prior taxable year, the tax for the subsequent taxable year is increased by the recapture amount. The recapture amount is the difference between the credit claimed in the prior taxable year and the redetermined credit. The redetermined credit is computed by reducing the amount of the qualified tuition and related expenses for which a credit was

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 credit using the redetermined qualified expenses and the relevant facts and circumstance of the prior taxable year, such as modified adjusted gross income.

The proposed regulations provide that, if, in a taxable year, any excludable educational assistance is received for the qualified tuition and related expenses paid during a prior taxable year, the educational assistance is treated as a refund of qualified tuition and related expenses. In this situation, if a taxpayer (or the taxpayer's spouse or a claimed dependent) receives any excludable educational assistance 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. However, if a taxpayer (or the taxpayer's spouse or claimed dependent) receives excludable educational assistance after the taxpayer has filed a federal income tax return for the prior taxable year, any education credit claimed for the prior taxable year is subject to recapture.

6. Proposed Effective Date

These regulations are proposed to be effective on the date they are published in the **Federal Register** as final regulations. Taxpayers may rely on these proposed regulations for guidance

pending the issuance of final regulations. If, and to the extent, future guidance is more restrictive than the guidance in the proposed regulations, the future guidance will be applied without retroactive effect.

Special Analyses

It has been determined that these proposed regulations are 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), this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written and electronic comments that are submitted timely to the IRS. The IRS and Treasury specifically request comments on the clarity of the proposed regulations and how they can be made easier to understand. All comments will be available for public inspection and copying.

A public hearing will be scheduled in the Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC. The IRS

recognizes that persons outside the Washington, DC, area may also wish to testify at the public hearing through videoconferencing. Requests to include videoconferencing sites must be received by March 8, 1999. If the IRS receives sufficient indications of interest to warrant videoconferencing to a particular city, and if the IRS has videoconferencing facilities available in that city on the date the public hearing is to be scheduled, the IRS will try to accommodate the requests.

The IRS will publish the time and date of the public hearing and the locations of any videoconferencing sites in an announcement in the **Federal Register**.

Drafting Information

The principal author of the regulations is Donna Welch, Office of Assistant Chief Counsel (Income Tax and Accounting). However, other personnel from the IRS and the Treasury Department participated in the development of the regulations.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be 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-0 also issued under section 26 U.S.C. 25A(i).

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 credit and general eligibility requirements.

(a) Amount of education 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) Coordination with Education IRA.
(f) Identification requirement.
(g) Claiming the credit in the case of a dependent.
(1) In general.
(2) Examples.
(h) Married taxpayers.
(i) 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 comprehensive fees.
(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) Payments of educational expenses by a third party.
(1) In general.
(2) Example.
(b) Expenses paid by dependent.
(1) In general.

(2) Example.
(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) Allocation of 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.
(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) Excludable educational assistance received in a subsequent taxable year treated as refund.
(5) Examples.

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

(a) Amount of education credit. An individual taxpayer is allowed a nonrefundable education credit against income tax imposed by chapter 1 of the Internal Revenue Code for the taxable year. The amount of the education 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, 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 any student for whom a Hope Scholarship Credit is claimed may not be taken into account in computing the amount of the Hope Scholarship Credit with respect to any other student or 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 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 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 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 credit is allowed unless a taxpayer elects to claim the credit on the taxpayer's timely filed (including extensions) 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)," (or its successor) to that federal income tax return.

(e) Coordination with Education IRA. No education credit is allowed for a taxable year for the qualified tuition and related expenses of a student if--

(1) During the taxable year, a distribution is made to, or on behalf of, the student from an education individual retirement account described in section 530(b) (Education IRA); and

(2) Any portion of the distribution is excluded from gross income under section 530(d)(2).

(f) Identification requirement. No education 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 section 6213(b) and (g)(2)(J).

(g) 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 credit for the student's qualified tuition and related expenses. However, if the taxpayer is eligible to, but does not, claim the student as a dependent, only the student may claim the education credit for the student's qualified tuition and related expenses.

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

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 credit on his federal income tax return, and B is not allowed an education 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(b).

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 credit on D's federal income tax return, and Taxpayer C is not allowed an education 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(a).

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

(i) 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 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 credit with respect to the qualified tuition and related expenses of the student unless the student is a dependent as defined in section 152. Among other requirements under section 152, the nonresident alien student must be a resident of a country contiguous to the United States in order to be treated as a dependent.

§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.

(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 (20 U.S.C. 1070 et seq.) 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 et seq.; 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 (such as a summer school session) as reasonably determined by an eligible educational institution.

(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 fee 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, 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 comprehensive fees. If a student is required to pay a comprehensive fee to an eligible educational institution that includes charges for tuition, fees, and personal expenses described in paragraph (d)(3) of this section, the portion of the comprehensive fee that is allocable to personal expenses is not a qualified tuition and related expense. The allocation must be made by the institution using a reasonable method.

(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, is taken by the student to acquire or improve job skills.

(6) Examples. The following examples illustrate the rules of this paragraph (d). In each example, assume that all other

relevant requirements to claim an education 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 not allocable to personal expenses, 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. 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 phase out of the education 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 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 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 x $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 student 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 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 standards 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) 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 enrolls full-time in an undergraduate degree program at College U for the 1998 Fall semester. For the 1999 Spring semester, Student A again enrolls at College U on a full-time basis. For the 1999 Fall semester, Student A enrolls 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 enrolls in half the normal full-time work load for his degree program. 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 enrolls in a full-time work load at College V for the 1999 Spring semester. 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.

Example 4. 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 takes a full-time work load during the 1998 Fall semester and during the 1999 Spring and Fall semesters. Because Student C was not enrolled in a college or other eligible educational institution prior to 1998 (but rather was classified as a second-semester sophomore by College W as of the start of the 1998 Fall semester solely because of proficiency examinations), Student C is not treated as having completed the first two years of postsecondary education at an eligible educational institution 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. 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 takes more than 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 more than 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 located in Country S. College S is not an

eligible educational institution for purposes of the education credits. At the end of 1998, Student E moves to the United States and enrolls in an undergraduate degree program at College Z on a full-time basis for the 1999 Spring semester. 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 was born and raised in Country R, and she received a degree in 1998 from College R located in Country R. College R is not an eligible educational institution for purposes of the education credits. During 1999, Student F moves to the United States and enrolls for the 1999 Fall semester on a full-time basis in a graduate-degree program at College Y. 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.

(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 enrolls full-time 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 phase out of the education 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 phase out of the education 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 he 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 noncredit 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) Payments of educational expenses 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, 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) Example. The following example illustrates the rule of this paragraph (a). In the example, assume that all the requirements to claim an education credit are met. The example is as follows:

Example. 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 credit, Student E is treated as receiving the money from her grandparent and, in turn, paying her qualified tuition and related expenses.

(b) Expenses paid by dependent--(1) In general. Qualified tuition and related expenses paid by a student are treated as paid by a taxpayer if the student is a claimed dependent of the taxpayer for the taxable year in which the expenses are paid.

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

Example. 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 (a) of this section, Student C is treated as receiving the money from Parent A and, in turn,

paying his 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. Parent B may claim an education credit for the qualified tuition and related expenses paid directly to the institution by Parent A.

(c) Adjustment to qualified tuition and related expenses for certain excludable educational assistance--(1) In general. In determining the amount of an education credit, qualified tuition and related expenses paid during the taxable year must be reduced by any amount paid to, or on behalf of, a student during the taxable year with respect to attendance at an eligible educational institution during an academic period beginning in that taxable year that is--

(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)(4) of this section.

(3) Allocation of scholarships and fellowship grants. For purposes of paragraph (c)(1) of this section, a scholarship or fellowship grant is treated as a qualified scholarship excludable from income under section 117 unless--

(i) The student reports the grant as income on the student's federal income tax return; or

(ii) The grant 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.

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

Example 1. University X charges Student A, who lives on X's campus, $3,000 for tuition and $5,000 for room and board. University X awards a $2,000 scholarship to Student A, which University X applies against Student A's $8,000 total bill. 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 and room and board. 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 classes. Student A does not report any portion of the scholarship as income on Student A's federal income tax return. The scholarship is a qualified scholarship that is excludable from Student A's income under section 117 and is allocable first to Student A's qualified tuition and related expenses. Therefore, for purposes of calculating an education 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 in addition to the scholarship that University X awards to Student A, University X also provides Student A with a student loan and pays Student A for working in a work/study job in the campus dining hall. The loan is not excludable educational assistance. 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 3. 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 credit, Student B is treated as having paid no qualified tuition and related expenses to University Y during 1999.

Example 4. The facts are the same as in Example 3, 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 wages to Student B. Because the reimbursement is not excludable employer-provided educational assistance, 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 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 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 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 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 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 the 1999 Spring semester, which begins in January 1999. Taxpayer A may claim an education credit only in 1998 for payments made in 1998 for the 1999 Spring semester.

(3) Expenses paid with loan proceeds. An education credit may be claimed for the 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 of disbursement. If a taxpayer does not know the date of disbursement, the taxpayer must treat the qualified tuition and related expenses as paid on the last date for payment prescribed by the institution.

(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.

(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 the taxpayer's spouse or a claimed dependent) receives a refund from an eligible educational institution of qualified tuition and related expenses paid 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 the taxpayer's spouse or a claimed dependent) receives a refund of qualified tuition and related expenses for which the taxpayer claimed an education 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 between the credit claimed in the prior taxable year and the redetermined credit. The redetermined credit is computed by reducing the amount of the qualified tuition and related expenses for which a credit was 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 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). Any redetermination of the tax liability for the prior taxable year (by audit or amended return) will be taken into account in computing the redetermined credit.

(4) Excludable educational assistance received in a subsequent taxable year treated as a refund. If, in a taxable year, any excludable educational assistance (described in paragraph (c)(1) of this section) is received for the qualified tuition and related expenses paid 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 a taxpayer (or the taxpayer's spouse or a claimed dependent) receives any excludable educational assistance 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 a taxpayer (or the taxpayer's spouse or a claimed dependent) receives excludable educational assistance after the taxpayer has filed a federal income tax return for the prior taxable year, any education credit claimed for the prior taxable year is subject to recapture as provided in paragraph (f)(3) of this section.

(5) Examples. The following examples illustrate the rules of this paragraph (f). In each example, assume that all the requirements to claim an education 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 an $800 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 $200 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 ($800 + $200 = $1,000); and, then

(iii) Subtracting (ii) from (i) ($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.

(ii) She calculates the increase in tax for 1999 by:

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

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

(C) 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 x $1,200). 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 credit claimed by Student C for 1998 is subject to recapture. Because Student C paid no net qualified tuition and related expenses in 1998, the redetermined credit for 1998 is zero. Student C must increase the amount of Student C's 1999 taxes by the recapture amount, which is $240 (the education credit claimed for 1998 ($240) minus the redetermined credit for 1998 ($0)). Because the $1,200 reimbursement is taken into account in calculating the $240 recapture amount for 1999, the reimbursement does not reduce the amount of any qualified tuition and related expenses that Student C paid in 1999.

Deputy Commissioner of Internal Revenue