

## AOC WORKBOOK EXPLANATION

This Workbook is designed to be an aid in optimizing the American Opportunity Credit (AOC) for most taxpayers that visit a VITA site. At the end of this explanation is a list of more complicated situations that the Workbook is not built to address. In these situations, you will either need to use the Education Calculator located at [www.cotaxaide.org/tools](http://www.cotaxaide.org/tools) or you will need to send the taxpayer to a paid preparer or ignore the optimization opportunity if the numbers are not significant enough to justify paying for a paid preparer.

The Workbook consists of two sheets. The first sheet "AOC Summary" is the only sheet you will need to touch. All required inputs are on this sheet, and it contains the answers you will need to optimize the AOC: whether the return is in scope due to the Kiddie Tax; the amount of Qualified Educational Expenses (QEE) that should be entered into TaxSlayer as QEE for the AOC on the return of the taxpayer claiming the credit; and the amount of scholarship income that should be entered on the student's return (if the student files a return). The second sheet contains the detailed calculations required to determine the answers and is there for your reference if you want to understand the detail.

This explanation will provide an overview of the first sheet and then a more detailed explanation of the second sheet. You do not need to read the more detailed discussion of the second sheet unless you are curious, but I have provided it for those of you who are.

Before beginning the Workbook, if there is a 529 Plan distribution during the year, you must first allocate QEE in an amount equal to the amount of the 529 distribution shown in Box 1 of the Form 1099-Q. Otherwise, the return of the taxpayer who received the 1099-Q (whose SSN is on the 1099-Q) will be out-of-scope. However, the definition of QEE for a 529 distribution is much broader than for the AOC as it includes, for example, room and board expenses (which may be less than the actual expenses). See Pub. 970 for the definition of qualifying educational expenses for Qualified Tuition Plans (which are 529 plans). You would first allocate the QEE for items such as room and board that are not eligible for the AOC before allocating any QEE that is eligible for the AOC. For the remainder of the Workbook, any reference to QEE amounts will only be the QEE after the allocation to any 529 distribution.

### AOC Summary Sheet

On this sheet, you will enter the information required for the Workbook to optimize the AOC. Before beginning, make sure all the yellow input boxes are clear. For all taxpayers, you should enter the Taxpayer's Name (so it will be on the printed copy). You will then need to enter the QEE and Scholarship information on Lines 1-3 and 5-6.

If Line 8 then says \$4,000, you are finished with the Workbook. Enter \$4,000 as the AOC QEE on the return of the taxpayer claiming the credit. There is no scholarship income to report.

If Line 8 says "Continue", proceed to Line 9 and enter the amount of any restricted scholarships, if any. A scholarship is restricted for this purpose if by its terms, it must be spent on Qualified Educational Expenses such as tuition and books, but may not be used on other

expenses such as living expenses, room & board, etc. The most common scholarships at most educational institutions are Pell Grants, NC-Need Based, and UNC-Need Based. All of these scholarships are unrestricted, as they can be used for expenses other than QEE.

Proceed to Lines 10-13 and answer each of these questions based on the information provided by the taxpayer. For Line 10, earned income for this purpose is income received for personal services (generally, wages or net earnings from self-employment income). Earned income includes any part of a scholarship or fellowship grant that represents payment for teaching, research, or other services performed that are required as a condition for receiving the scholarship or grant. Any other scholarship income is NOT included in earned income for this purpose. In determining support, scholarships are ignored, so you will be comparing the earned income of the student to everything spent on behalf of the student during the year that was not paid for with a scholarship. For Line 13, the student should be claiming the AOC only if the student is not eligible to be claimed as a dependent on another taxpayer's return.

After completing these questions, Line 14 will then instruct you as to whether any additional Lines must be completed, and if so, which ones. If Line 14 says "None", no more information is required, and you should go to Lines 24-26 for the answers.

If Line 14 says "Lines 15 & 16" you will need to enter the student's earned income (as defined above) and the student's unearned income if any (generally interest, dividends, capital gains, and Military Survivor Benefits). For unearned income, ignore any scholarship income (just as you generally do for earned income). After entering the student's earned income and unearned income, Lines 24-26 provide the final answers.

If Line 14 says "Lines 15-19", you must first complete the student's return in TaxSlayer. Be aware that this should be a relatively unusual situation, as this requires that the student be providing less than half of his/her own support from earned income but is claiming the AOC. A student who is eligible to be claimed as a dependent should not be claiming the AOC other than in very unusual situations as the other taxpayer who can claim the student will almost always obtain a greater benefit from claiming the AOC than the student. In completing the student's initial return, you will enter scholarship income to the extent Line 7 of the Workbook exceeds Line 4, and you will enter QEE for the AOC to the extent Line 4 of the Workbook exceeds Line 7. (NOTE: The prior sentence assumes there are no restricted scholarships. If there are restricted scholarships, substitute Line 13 of the Detail sheet for the QEE shown on Line 4 and substitute Line 14 of the Detail sheet for the scholarship amount shown on Line 7.) This return represents your base case, "unoptimized" return. You will then need to enter the student's earned income on Line 15, unearned income on Line 16, and then answer the question on Line 17. If the answer is YES, Lines 24-26 of the Workbook will give you the final answers.

If the answer to Line 17 is NO, you will need to enter two pieces of information from the student's return: (1) on Workbook Line 18, enter the student's Taxable Income from Form 1040, Line 15; and (2) on Workbook Line 19, enter the amount of tax shown on Form 1040, Line 22. Workbook Lines 24-26 will then provide the final answers. As the student would be

claiming the AOC in this situation (since you had to say Yes to the question on Line 13 to get to this portion of the Workbook), you would replace any scholarship income or AOC QEE entered in the return as originally created with the numbers shown on Lines 25 and 26 (if the return is in scope).

If Line 14 says “Lines 20-23”, you must also complete the student’s return. This situation arises if the student is claiming the AOC and is not subject to the refundability limitations or the Kiddie Tax, for example, if the student is over 23 years old. In this situation, complexity is created by the potential impact on the Earned Income Credit of adding scholarship income. To complete Lines 20-23, follow the same steps described above for Lines 15-19 to create an “unoptimized” tax return for the student. Then answer the questions on Lines 20-23. The answer will appear on Lines 24-26. As the student would be claiming the AOC in this situation (since you had to say Yes to the question on Line 13 to get to this portion of the Workbook), you would replace any scholarship income or AOC QEE entered in the return as originally created with the numbers shown on Lines 25 and 26 (if the return is in scope).

Once you have completed the first sheet, please print it for Quality Review and for the taxpayer’s records.

In the explanation below of the Detail sheet, there are a number of examples that you may want to review to see how the Workbook functions.

## **Explanation of the DETAIL Sheet**

It is not necessary for you to read this portion unless you want to understand the mechanics of the Workbook in greater detail. The following explanation goes through the second spreadsheet entitled “Detail” and explains the mechanics of the spreadsheet. **All the inputs are made on the first sheet (“AOC Summary”) and automatically carryover to the second sheet.**

### **STEP 1 – TOTAL QEE & TOTAL SCHOLARSHIPS**

Determine the total amount of the student’s Qualified Educational Expenses (QEE) for 2022 (generally tuition, books, supplies, and mandatory fees) and determine the total scholarships and grants received by the student during 2022. Remember that if there are 529 distributions to first follow the instructions above and only treat QEE eligible for the AOC that remain after such allocation as QEE eligible for the AOC. Go to **STEP 2**.

### **STEP 2 – QEE EXCEEDS SCHOLARSHIPS BY > \$4,000**

Does the Total QEE exceed the Total Scholarships amount by \$4,000 or more?

If YES, use \$4,000 as the amount of QEE for the AOC on the return of the taxpayer claiming the education credit (for example, the parents’ return if they are claiming the student as a dependent) and you are finished with education. There would be no scholarship income to report.

If NO, go to **STEP 3**.

### **STEP 3 – RESTRICTED SCHOLARSHIPS**

Determine whether the student has any restricted scholarships, which are scholarships that by their terms may only be spent on items that qualify as QEE. For example, a scholarship that allows monies to be spent on room and board or other living expenses would not be a restricted scholarship (such as Pell Grants), while a scholarship that may only be used to pay tuition would be a restricted scholarship. If there are restricted scholarships, reduce the Total QEE by the amount of the restricted scholarships in order to come up with the Total Allocable QEE for the remaining steps.

### **STEP 4 - LIMITATIONS**

This step is designed to determine whether the student is potentially subject to the Kiddie Tax. If so, we must limit scholarship income (if possible) to avoid the Kiddie Tax to keep the student's return in scope. The following 3 conditions must be satisfied for the Kiddie Tax to potentially apply:

1. The student is one of the following:
  - a. under the age of 18 at the end of 2022;
  - b. age 18 at the end of 2022 and her earned income is less than  $\frac{1}{2}$  of her total support; or
  - c. over 18 and under 24 at the end of 2022, a full-time student, and her earned income is less than  $\frac{1}{2}$  of her total support.
2. At least one of the student's parents is alive at the end of 2022.
3. The student is not filing an MFJ return.

If these 3 conditions are not satisfied, we can optimize the AOC without worrying about the Kiddie Tax and Option 4A does that.

If the 3 conditions are satisfied and the AOC is being claimed by a taxpayer other than the student (for example, the student's parents), we need to limit the scholarship income reported on the student's return to the maximum scholarship income that the student can have and still avoid the Kiddie Tax. We need the student's earned income and unearned income to be able to calculate the maximum scholarship income that can be reported to avoid the Kiddie Tax. Option 4B will then calculate the maximum scholarship income that avoids the Kiddie Tax and will also tell us if that limit is exceeded even without optimizing, in which case the student's return is out-of-scope.

If the 3 conditions are satisfied and the AOC is being claimed by the student, a further limitation applies. In this case, the student's AOC will be nonrefundable. In this situation, in addition to worrying about the Kiddie Tax, we want to limit the amount of scholarship income we create to optimize the AOC so that we are creating sufficient AOC to wipe out the student's tax liability (which is all we can do with a nonrefundable credit) without creating additional

scholarship income that would be subject to tax at the state level. Option 4C will make these calculations.

Remember that if the student is eligible to be claimed by someone else, it is almost always better for that taxpayer to claim the credit rather than the student. If the student still wants to claim the credit even though eligible to be claimed by another taxpayer, you should try to understand why the student wants to claim the credit and be sure the explanation makes sense.

#### ***OPTION 4A – PARENTS CLAIMING REFUNDABLE AOC WITH NO KIDDIE TAX LIMIT***

We will allocate QEE against the AOC. The QEE that will be allocated to the AOC will equal the Total Allocable QEE up to a maximum of \$4,000. Any QEE over \$4,000 will be allocated to offset scholarship income.

So, for example, if the Total Allocable QEE equals \$10,000 and the Total Unrestricted Scholarships equal \$13,000, the QEE allocated to the AOC will equal \$4,000. This leaves \$6,000 (\$10,000-\$4,000) of QEE to allocate against scholarships, leaving \$7,000 (\$13,000-\$6,000) of scholarship income.

#### ***OPTION 4B – PARENTS CLAIMING REFUNDABLE AOC WITH KIDDIE TAX LIMIT***

If the AOC is being claimed by a taxpayer other than the student and the student satisfies the 3 requirements for the Kiddie Tax to potentially apply, we may have to limit the amount of scholarship income on the student's return to prevent the Kiddie Tax from applying and making the student's return out of scope (the return of the taxpayer claiming the student remains in scope).

In such cases, the student's scholarship income must be limited as follows:

1. If the student's unearned income (not including any scholarship income) exceeds \$2,300, the student is subject to the Kiddie Tax and the student's return is out of scope.
2. If the student's earned income exceeds \$12,950 OR the student's unearned income exceeds \$400, the Maximum Scholarship Income will be \$2,300 less the student's unearned income (such as interest, dividends and capital gains but not including any scholarship income).
3. If the student's earned income is less than or equal to \$10,650 and the student's unearned income is less than or equal to \$400 of unearned income), the student's Maximum Scholarship Income will be \$12,950 less the student's gross income (not including any scholarship income), i.e., earned income plus unearned income.
4. If the student's earned income is more than \$10,650 but less than \$12,950 and the student's unearned income is equal to or less than \$400 of unearned income), the student's Maximum Scholarship Income will be \$2,300 less the student's unearned income (not including any scholarship income).

5. If the difference between the student's Total Unrestricted Scholarships and Total Allocable QEE is less than the Maximum Scholarship Income from 2, 3, or 4 above, the student is subject to the Kiddie Tax and the student's return is out of scope.

**If the return is in scope (neither 1 nor 5 apply), we will allocate QEE as follows:**

1. To Total Unrestricted Scholarships in an amount equal to the difference between the Total Unrestricted Scholarships and the Maximum Scholarship Income in order to avoid the Kiddie Tax;
2. Any remaining QEE will be allocated to the AOC up to \$4,000 and will be reported on the return of the taxpayer claiming the AOC as AOC QEE; and
3. Any remaining QEE after allocation 2 will be allocated against Total Unrestricted Scholarships to reduce the amount of scholarship income. The student's scholarship income will equal the Maximum Scholarship Income less any QEE allocated against scholarships after the allocation to the AOC.

For example, the student had earned income of \$10,000 and unearned income of \$100 (ignoring scholarship income). The student had Total Unrestricted Scholarships of \$8,000 and Total Allocable QEE of \$10,000. Item 3 above will apply to determine the Maximum Scholarship Income. Thus, the Maximum Scholarship Income will equal \$12,950-\$10,000 (earned income) - \$100 (unearned income) for a total of \$2,850. In order to avoid the Kiddie Tax, we must first allocate enough QEE to reduce the scholarship income to \$2,850, which will be the difference between the Total Scholarship Income (\$8,000) and the Maximum Scholarship Income (\$2,850), or \$5,150. The remaining QEE will be \$4,850 (\$10,000 - \$5,150). Of this amount, we will allocate \$4,000 to the AOC and the remaining amount of \$850 will be allocated against scholarships. Thus, the AOC QEE will equal \$4,000, and the Scholarship Income will equal \$2,000 (\$8,000 Total - \$5,150 Initial - \$850 Final).

***OPTION 4C – STUDENT CLAIMING THE AOC AND IS NOT ELIGIBLE FOR THE REFUNDABLE PORTION OF THE AOC***

As a reminder, this will only be the case where the student is claiming the AOC. Because of the nonrefundability of the credit, the AOC will only be available to offset other income tax owed by the student. If prior to optimizing the education benefit, the student does not owe any income tax, there is no reason to proceed with trying to include any scholarship income on the student's return to generate AOC.

As a starting point, we must determine whether any benefit can be derived from including additional scholarship amounts in the income of the student. In order to do this, take the following steps:

1. Complete the student's return other than education issues (AOC or scholarship income).
2. If the Total Allocable QEE exceeds the student's Total Unrestricted Scholarships, enter the difference as QEE for the AOC.

3. If the Total Unrestricted Scholarships exceed the Total Allocable QEE, enter the difference as scholarship income on the student's return.
4. Look at the completed Form 1040, Line 22, If the amount is zero, stop here as there is no need to optimize. Otherwise continue.

Because the student is not eligible for the refundable AOC, the student's AOC is nonrefundable (be sure to check the box in TaxSlayer) and the return will be **out of scope** unless the amount of scholarship income is limited to avoid the Kiddie Tax. In this situation, in order to keep the student's return in scope, the student's scholarship income must be limited to the greater of:

- a. The difference between \$12,950 (\$19,400 for HoH) and the student's total income (prior to adding any scholarship income); and
- b. \$2,300 minus any unearned income (such as interest, dividends, or capital gains).

NOTE: The following assumes that the student is filing a Single return. The only other possibilities are Head of Household or Qualifying Widow (as MFJ kicks you out of the Kiddie Tax and nonrefundability rules and MFS doesn't qualify for the AOC). This adds complexity to the calculations that are not justified for the few taxpayers that could fall into this category. If these are your facts, use the Education Calculator at [www.cotaxaide.org/tools](http://www.cotaxaide.org/tools).

FIRST CHECK – If the difference between the Total Unrestricted Scholarships and the Total Allocable QEE exceeds the maximum scholarship income amount, the Kiddie Tax will apply, and the return is out of scope.

If the return is in scope, the amount of additional Scholarship Income and additional QEE we want to add to the return in addition to what we included as our starting point will equal the lesser of:

1. Line 22 of the 1040 divided by 0.9; or
2. Total Allocable QEE less the difference between Total Unrestricted Scholarships and the Maximum Scholarship Income.

Note: If the Taxable Income shown on Line 15 is greater than \$9,248, substitute 0.88 for 0.9 in the above computation. However, this would be a quite unusual set of facts as it would mean the student has AGI of at least \$22,198, but we would have concluded that the student's earned income is less than half of the student's support, ignoring scholarships. Obviously, this could happen if the student had significant unearned income such as interest, dividends, and capital gains, but we don't tend to see these students at VITA sites.

Lines 57-59 show the final results. The amounts shown in Lines 51 and 52 represent the total QEE and Scholarship Income and should replace any amounts shown in the base case, unoptimized return.

For example, the student had earned income of \$13,000 and unearned income of \$100 (ignoring scholarship income). The student had Total Unrestricted Scholarships of \$11,000

and Total Allocable QEE of \$10,000. We complete the student's return in TaxSlayer. Because the scholarship exceeds the QEE by \$1,000, we enter \$1,000 in scholarship income to the student's return. This creates taxable income of \$1,150 and tax due of \$116. After entering all this data on the AOC Summary sheet, Line 42 of the Detail sheet tells us her maximum scholarship income to avoid the Kiddie Tax is \$2,200. We divide her tax amount (\$116) by 0.9, which gives us \$129. This becomes our AOC QEE, and we also add this same amount to her original scholarship of \$1,000 to give her total scholarship income of \$1,129 (which is less than the maximum of \$2,200). When we enter the AOC QEE of \$129 and the total scholarship income (replace the original \$1,000 amount with the new total of \$1,129) on her return, her tax before nonrefundable credits is \$129, but the AOC of \$129 reduces her tax liability to \$0.

#### ***OPTION 4D – STUDENT CLAIMING THE AOC AND IS ELIGIBLE FOR THE REFUNDABLE PORTION OF THE AOC***

This situation arises when the student is claiming the AOC but is not subject to the Kiddie Tax and the AOC is refundable. In this situation, we have to first determine whether the student is entitled to the Earned Income Credit on the unoptimized return before we can optimize. If the student is able to claim the EIC, we have to take into account the impact on the EIC of adding more scholarship income when optimizing.

As with Option 4C:

1. Complete the student's return other than education issues (AOC or scholarship income).
2. If the Total Allocable QEE exceeds the student's Total Unrestricted Scholarships, enter the difference as QEE for the AOC.
3. If the Total Unrestricted Scholarships exceed the Total Allocable QEE, enter the difference as scholarship income on the student's return.

Then answer the questions on Lines 20-23 of the first page of the Workbook.

Lines 57-59 show the final results. The amounts shown in Lines 58 and 59 represent the total QEE and Scholarship Income and should replace any amounts shown in the base case, unoptimized return.

For example, the student had earned income of \$15,000 and unearned income of \$100 (ignoring scholarship income). The student has a 2-year-old daughter who qualifies her for the CTC and EIC. She files as Head of Household. The student had Total Unrestricted Scholarships of \$11,000 and Total Allocable QEE of \$10,000. We complete the student's return in TaxSlayer. Because the scholarship exceeds the QEE by \$1,000, we enter \$1,000 in scholarship income to the student's return. Her unoptimized return shows a refund of \$5,233 (assuming no withholding), including an EIC of \$3,733.

We then enter the information requested on Lines 20-23 of the first page of the Workbook. She is entitled to the EIC on her unoptimized return, is filing Head of Household, has \$16,100 of AGI on her unoptimized return, and has one qualifying child for the EIC. Lines 57-59 of the



Detail sheet show that her return is in scope, she has AOC QEE of \$4,000 and scholarship income of \$5,000. We replace her scholarship income of \$1,000 with the revised amount of \$5,000 and add her AOC QEE of \$4,000. Her total refund goes from \$5,233 to \$6,233 (she gets the benefit of the \$1,000 refundable amount of the AOC) and her EIC remains at \$3,733.

## CAVEATS

*This Workbook is designed to work in the vast majority of cases seen at VITA sites. However, it is not intended to work in certain cases which are too complex for a relatively simple spreadsheet. Here are examples of situations where this workbook may not provide the correct result and you would either need to use the Education Calculator at [www.cotaxaide.org/tools](http://www.cotaxaide.org/tools) or send the taxpayer to a paid preparer:*

1. The taxpayer has more than one student with respect to which education credits are being claimed or other scholarship income is reported (in most cases, the Education Tool can handle these, but it's not easy).
2. The student's return has certain complexities to it such as Social Security income, IRA deductions, other credits that are impacted by the student's income, such as the Premium Tax Credit, or other unusual items impacted by the amount of the student's income. It does account for the impact of optimizing on the EIC and CTC. The Education Calculator can correct for some of the other complexities that can arise, but not all. See the Instructions to the Education Calculator.
3. This workbook only works for student returns where the AOC is nonrefundable if the student's filing status is Single. If it is Head of Household or Qualifying Widow, use the Education Calculator.
4. This workbook does not factor in the Income Threshold limits on the AOC as this should be a rare event at a VITA site (and I don't think the Education Calculator would work in these situations either). These limits are \$160,000 for an MFJ return and \$80,000 for all other filing statuses.
5. The workbook does not account for the state tax impact. The state tax effects are not likely to materially change the optimal answer provided in the workbook.

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