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How Students and Families Can Best Use the American Opportunity Tax Credit

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Students and families taking advantage of a popular education breaks should take note that the credit formerly known as the Hope Credit has undergone a face lift and has been enhanced. In fact, the credit has changed in six ways between 2009 and 2012.

Originally, the Hope credit was available for only the first two years of college, but the American Recovery and Reinvestment Act of 2009 changed the name to the American Opportunity Tax Credit, and the credit can now be claimed for the first four years of college. Note that any postgraduate work does not apply, but the Lifetime Learning Credit can be used for that.

The maximum credit was originally $1,800, but it has grown to $2,500 and may offset the alternative minimum tax, something it was not eligible for previously. The credit is now up to 40% refundable. In general, credits apply to an existing tax liability and if the credit is greater than the tax liability, you either lose the remainder of the credit balance or you may carry it forward to subsequent tax years. In this case however, it's refundable so even if you have no tax liability, you would still get money back.

Before 2009 the Hope credit applied to tuition and fees. Now the credit allows the inclusion of course materials and computers. With that said, there are still limitations. I've always said that if you can afford to send your kids to college, you won't get the credit. It's still true. If your adjusted gross income is between $80,000-$90,000 (single or head of household) and $160,000-$180,000 (married filing joint) the credit is phased out – you don't get the entire amount.

If you make more than the top of the range: $90,000 (single or head of household) and $180,000 (married filing joint), you aren't eligible for the credit and you cannot carry forward any unused credit to subsequent tax years.

If you fall into the income ranges where the credit is phased out completely, you may want to consider letting your child take the credit. However, this only works if the child is working and is required to file a tax return. If you choose this option, you can't take the child as a dependent on your own tax return, and the child cannot take his own personal exemption even though his parents are not claiming it. Usually, the credit is large enough that the resulting additional tax would be absorbed by it. The other caveat is that if the child is subject to the kiddie tax (kiddie tax is based on earnings through dividends, interest, and capital gains), the credit will be limited to his tax liability; he is not entitled to any part of the credit that is refundable.

Here's an example: Sarah is 22 and a full time student. Her parents provide more than half of her support and are entitled to take Sarah as a dependent and are entitled to the American Opportunity Credit in the maximum amount of $2,500. However, their adjusted gross income is $200,000, which is $20,000 higher than the amount allowed in order to take the credit. Sarah worked a part-time job all year and made $10,000. Normally, she would file a tax return and check the box stating that someone else could take her as a dependent. She would pay any ensuing tax liability. However, this year, she will file on her own and apply the credit toward any taxes owed.

Tax law is constantly changing, which makes it important for students and their parents to study how to get the best return on their college investment.

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