PacificCPE

COURSE
34252A

Individual Income Tax Credits: Part 2

Refundable and partially refundable credits can significantly impact a client's tax outcome—and they come with serious practitioner responsibilities. This course covers how refundable credits work, what makes them different from nonrefundable credits, and what due diligence requirements apply when preparing returns that claim these benefits. Tax professionals who prepare individual returns will find this course especially practical for staying compliant, avoiding penalties, and confidently advising clients on credits they may qualify for.

CREDIT HOURS 2 | FIELD OF STUDY TAXES | EXAM QUESTIONS 10

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Assignment

- Study the full course materials included here.
- Complete the review questions after each chapter.
- Answer 10 final exam questions.
- Final exam is scored immediately, 70% or better passes.
- Certificate of completion is available in your account.
- Failed exams can be retaken free of charge.

Course Objectives

- Identify the income tax credits that are refundable in whole or in part.
- Recall the eligibility requirements for claiming the Additional Child Tax Credit.
- Identify attributes of the American Opportunity Tax Credit.
- Recall the eligibility requirements for claiming the Adoption Tax Credit.
- Identify the requirements that apply to claiming the Earned Income Tax Credit.
- Recall how to calculate the Premium Tax Credit.
- Recall the due diligence requirements a tax preparer must meet when preparing a tax return claiming the Earned Income Tax Credit (EITC), American Opportunity Tax Credit (AOTC), Child Tax Credit (CTC), Additional Child Tax Credit (ACTC), and Other Dependent Credit (ODC).
- Recognize the records a tax return preparer is required to keep to support a client's claim for the EITC, AOTC, CTC, ACTC, and ODC.
- Identify thepenalties thatmaybeimposed onataxpreparer forfailing tocomplywithduediligence requirements when preparing a client's tax return claiming the EITC,AOTC, CTC,ACTC, or ODC;

- Recognize the sanctions that may be imposed on an employer whose employee fails to comply with EITC, AOTC, CTC, ACTC, and ODC due diligence requirements.
- Identify the additional requirements imposed on taxpayers claiming the EITC,AOTC, CTC,ACTC, and ODC following disallowance and the exceptions to those requirements.

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Chapter 1: PARTIALLY AND FULLY REFUNDABLE INCOME TAX CREDITS

Chapter Objective

After completing this chapter, you should be able to:

- Identify the income tax credits that are refundable in whole or in part.
- Recall the eligibility requirements for claiming the Additional Child Tax Credit.
- Identify attributes of the American Opportunity Tax Credit.
- Recall the eligibility requirements for claiming the Adoption Tax Credit.
- Identify the requirements that apply to claiming the Earned Income Tax Credit.
- Recall how to calculate the Premium Tax Credit.

INTRODUCTION

Unlike the nonrefundable tax credits examined in Chapter 2 of course 34251B and 3, this chapter discusses those tax credits that are partially or fully refundable. Accordingly, Chapter 1 will look at the partially refundable Additional Child Tax Credit (ACTC) and the American Opportunity Tax Credit (AOTC), and the Adoption Tax Credit (ATC). Additionally, it will discuss the fully refundable Earned Income Tax Credit (EITC) and the Health Insurance Premium Tax Credit (PTC).

PARTIALLY REFUNDABLE TAX CREDITS

The partially refundable tax credits discussed in Chapter 1 are the:

- Additional Child Tax Credit (ACTC);
- American Opportunity Tax Credit (AOTC); and
- Adoption Tax Credit (ATC)

Additional Child Tax Credit

The Additional Child Tax Credit (ACTC) is the refundable portion of the Child Tax Credit (CTC) discussed in Chapter 2 of course 34251B. As a partially refundable tax credit, taxpayers who receive less than the full amount of the CTC may claim the credit even though they have no federal income tax liability. Thus, even though the Child Tax Credit is limited to no more than the lesser of the credit or the taxpayer's tax liability, the Additional Child Tax Credit is payable even if the taxpayer has no tax liability.

TheACTC—a tax credit that may not exceed $1,700 (2026) per qualifying child—is available to taxpayers who have been denied some or all of the CTC because their tax liability is less than the full CTC for which they would otherwise be eligible. (**Note**: Only the CTC may be used to figure the amount of any ACTC that can be claimed by a taxpayer; the ODC is not taken into account for purposes of figuring the ACTC.) A taxpayer that files IRS Form 2555, Foreign Earned Income, is ineligible to claim the ACTC.

American Opportunity Tax Credit

A taxpayer whose income does not exceed certain limits may be able to claim an American Opportunity Tax Credit of up to $2,500 for qualified education expenses paid for each eligible student, part of which is a refundable credit. Thus, the maximum American opportunity credit for any taxpayer is equal to $2,500 times the number of eligible students.

Various eligibility requirements must be met to claim the American Opportunity Tax Credit. Through the end of 2025, the identification requirement could be satisfied with:

- A Taxpayer Identification Number (TIN);
- An Individual Taxpayer Identification Number (ITIN);
- An Adoption Taxpayer Identification Number (ATIN); or
- A Social Security Number (SSN).

However, for tax years 2026 and later, only a Social Security Number (SSN) for the taxpayer, the taxpayer’s spouse (if filing jointly), and the student will be considered an acceptable form of identification when claiming the American Opportunity Credit. A taxpayer’s Taxpayer Identification Number (TIN), Individual Taxpayer Identification Number (ITIN), or the Adoption Taxpayer Identification Number (ATIN) will no longer be considered acceptable identification when claiming the credit.

The American Opportunity Tax Credit is available only for the first four years of postsecondary education during which time the student must be pursuing a degree or other recognized credential. The following is an overview of the credit:

Maximum credit	Up to $2,500 credit per eligible student (taxpayer, spouse or dependent).
Income limitations	Credit will be reduced if taxpayer’s MAGI exceeds $80,000 ($160,000 MFJ) and will fully phase out at $90,000 ($180,000 MFJ).
Credit type	Description
Credit type	40% of credit may be refundable; balance nonrefundable.
Eligible education years	Available only for first four years of postsecondary education.
Maximum tax years	Available only for four tax years per eligible student.
Degree requirement	Must be pursuing a degree or other recognized education credential.
Enrollment status	Must be enrolled at least half-time for at least one academic period beginning during the tax year.
Qualified expenses	Tuition, required enrollment fees and course materials the student needsfor a course of study as a condition of enrollment or attendance. Room & board not a qualified expense.
Drug convictions	Student must not have been convicted of a felony for controlled substance possession or distribution.
Academic periods	Payments made during the tax year for academic periods beginning during the tax year or in the first three months of the following year.

Figuring the American Opportunity Tax Credit

The maximum amount of the American Opportunity Tax Credit for each eligible student is $2,500 and is equal to the sum of:

- 100% of the first $2,000 of qualified education expenses paid by the taxpayer for the eligible student; plus
- 25% of the next $2,000 of qualified education expenses the taxpayer paid for the eligible student.

Thus, in order to claim the full $2,500 American Opportunity Tax Credit for each eligible student, the taxpayer must have paid at least $4,000 of qualified education expenses. (100% x $2,000 = $2,000; $25% x $2,000 = $500; $2,000 + $500 = $2,500). However, a taxpayer's American Opportunity Tax Credit may be reduced based on his or her MAGI.

Maximum American Opportunity Tax Credit Subject to Income Limits/Filing Status

A taxpayer's American Opportunity Tax Credit is gradually reduced if he or she files a single, head of household, or qualifying surviving spouse tax return and his or her MAGI exceeds $80,000; it is eliminated completely for such a taxpayer at a $90,000 MAGI. Similarly, if the MAGI of a taxpayer filing a joint return exceeds $160,000, his or her maximum American Opportunity Tax Credit is gradually reduced until it is eliminated at a $180,000 MAGI.

For most taxpayers, modified adjusted gross income (MAGI) is the taxpayer's adjusted gross income (AGI) as figured on their federal income tax return. However, in some cases, determining a taxpayer's MAGI, for purposes of the American Opportunity Tax Credit, requires additional modifications.

When the taxpayer files IRS Form 1040, the taxpayer's MAGI is his or her AGI, modified by adding back any of the following that apply:

• Foreign earned income exclusion;	• American Samoa residents' income exclusion; and
• Foreign housing exclusion;	• Puerto Rico residents' income exclusion.
• Foreign housing deduction;	

The equation that may be used to determine the reduction in the tentative American opportunity credit is shown below:

$$\text{Tentative American Opportunity Tax Credit} \times \frac{\text{MAGI} - \text{Applicable Amount}}{\$10{,}000\ (\$20{,}000\ \text{filing jointly})} = \text{Reduction}$$

The dollar amounts applicable to the American Opportunity Tax Credit are as shown in the following chart:

Taxpayer's Filing Status	Applicable Amount	Credit Eliminated
Single, head of household or qualifying surviving spouse	$80,000	$90,000
Married filing jointly	$160,000	$180,000

For example, suppose a taxpayer's tentative American Opportunity Tax Credit is $2,500 because he or she meets the requirements for the credit and has adjusted qualified education expenses amounting to $4,000. However, the taxpayer files a single tax return and has a MAGI of $82,500, i.e., $2,500 more than the applicable dollar amount. By substituting the appropriate values into the equation, we can see that the taxpayer's American Opportunity Tax Credit is reduced by $625, as shown below:

$$\$2{,}500 \quad X \quad \frac{\$82{,}500 - \$80{,}000}{\$10{,}000} \quad = \quad \$625$$

Thus, by reducing the tentative credit by the reduction, we can see that the taxpayer's American Opportunity Tax Credit in this case is $1,875 ($2,500 - $625 = $1,875).

We can also determine the reduction in the tentative American Opportunity Tax Credit if the taxpayer files a joint tax return and has a MAGI of $165,000 by making similar substitutions. The difference is the applicable dollar amount and the denominator of the fraction in the equation. In this example the taxpayer's American Opportunity Tax Credit is also reduced by $625, as shown in the following equation:

$$\$2{,}500 \quad X \quad \frac{\$165{,}000 - \$160{,}000}{\$20{,}000} \quad = \quad \$625$$

Instead of using the equation to determine the reduction in the tentative American Opportunity Tax Credit and then subtracting the reduction, the reduced credit may be determined by using Form 8863.

Refundable Part of the American Opportunity Credit

Part of the American Opportunity Tax Credit is generally refundable and part is nonrefundable. Forty percent of the American opportunity credit is refundable for taxpayers whose credit is more than the tax owed (up to $1,000). Some taxpayers, however, cannot claim any part of the American Opportunity Tax Credit as a refundable credit. The allowable credit for such taxpayers is limited to the nonrefundable portion of the credit only.

A taxpayer does not qualify for the refundable portion of the American opportunity credit if items 1 (a, b or c), 2 and 3 below apply:

1. The taxpayer is –

a) Under age 18 at the end of the tax year, or b)Age 18 at the end of the tax year and has an earned income less than one half of his or her support, or c)Over age 18 and under age 24 at the end of the tax year and a full-time student and has an earned income that was less than one half of his or her support;

2. At least one of the taxpayer's parents was alive at the end of the tax year; and

3. The taxpayer is filing a return as single, head of household, qualifying surviving spouse, or married filing separately for the tax year.

The term "earned income" includes a) wages, salaries, tips, and other taxable employee pay, b) net earnings from self-employment, and c) gross income received as a statutory employee. The term "support" includes all amounts spent to provide a person with food, lodging, clothing, education, medical and dental care, recreation, transportation, and similar necessities. A taxpayer is considered a full-time student if during any part of any five calendar months during the year the taxpayer was enrolled as a full-time student at an eligible educational institution or took a full-time, on-farm training course given by such an institution or by a state, county, or local government agency.

ADOPTION CREDIT

Federal tax laws encourage the adoption of children by granting an adoption credit and excluding amounts received from an employer to pay adoption expenses. The adoption credit is a tax credit designed to offset qualified adoption expenses for eligible taxpayers adopting an eligible child or children. A portion of the adoption credit is refundable. For 2026, the refundable portion of the adoption credit is $5,120. The adoption assistance program enables a taxpayer to exclude from income any amounts:

- Paid by the taxpayer to adopt an eligible child; or