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MEMORANDUM FOR MR. JOHN ZELLER
ASSOCIATE AREA COUNSEL
SB/SE

FROM: Heather C. Maloy
Associate Chief Counsel
Income Tax & Accounting

SUBJECT: Louisiana Tuition Program for Students (TOPS)

This Chief Counsel Advice responds to your memorandum dated July 13, 2000. In accordance with § 6110(k)(3) of the Internal Revenue Code, this Chief Counsel Advice should not be cited as precedent.

Your memorandum analyzes the federal income tax treatment of awards made under the Louisiana Tuition Opportunity Program for Students (TOPS). The TOPS awards consist of payments made by an agency of the State of Louisiana either directly to or on behalf of Louisiana students enrolled in post-secondary education programs.[1/] We concur with and restate here your views and analysis concerning the interrelationship of the TOPS award with §§ 25A and 117 of the Internal Revenue Code in the situations you presented. In accordance with discussions between members of our respective staffs, we are amplifying and clarifying your analysis and applying it in some additional situations which may arise. Our analysis is based on the proposed regulations under §25A; we will be happy to consult further with you as needed upon publication of final regulations.

ISSUES:

1. How may a student receiving a TOPS award treat that award under §§ 25A and 117 of the Code?

1/ We concur with your view that this memorandum should be limited to the TOPS award, as amended by the Louisiana legislature and effective July 12, 1999. Although the analysis may be similar for other tax-free educational assistance awards, those awards should be analyzed based on their specific facts.

2. What are the tax consequences to a student who delays receiving a TOPS award until after he (or his parent or guardian) files his income tax return?

CONCLUSIONS:

1. The tax treatment of a TOPS award depends on whether the award is included in, or excluded from, the gross income of the recipient. If the student establishes that an amount greater than or equal to the award is used to pay qualified tuition and related expenses, the student may exclude the amount of the award from gross income under § 117, but any § 25A education tax credit shall be calculated based upon the total qualified tuition and related expenses paid by the taxpayer less the amount of the TOPS award. If, however, the recipient includes the TOPS award in income and pays the qualified tuition and related expenses with his own funds, there will be no reduction to the total qualified tuition and related expenses upon which the § 25A credits are calculated.

2. The delayed receipt of a TOPS award that is excluded under § 117 is treated by the proposed regulations as a refund of qualified tuition and expenses paid. The proposed regulations provide that, if in a taxable year (refund year), a taxpayer or someone other than the taxpayer receives a refund of qualified tuition and related expenses paid on behalf of a student for which the taxpayer claimed an education tax 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. We recommend that the examination functions of the Internal Revenue Service should take the steps necessary to assure that the § 25A credits are properly recaptured in the subsequent year.

FACTS:

Under the Louisiana Tuition Opportunity Program for Students (TOPS), the Louisiana legislature provides state-funded financial assistance to Louisiana residents enrolled in post-secondary education programs at public and accredited private institutions within the state. La. Rev. Stat. ann. § 17:3048:1 (West Supp. 2000). Section 17:3048:1 contains detailed rules on the eligibility requirements for initial receipt and subsequent retention of TOPS awards. In general, the award money is appropriated annually by the legislature to an administrative agency; the agency in turn makes a direct payment, on behalf of a qualifying student, to the institution in which the student is enrolled. Section 17:3048:1.E.(1).

The TOPS statute originally provided that TOPS' awards made on behalf of qualified students' were to be used for tuition. However, in 1999 the Louisiana legislature went from a system that required a TOPS award to be used for tuition to a system that measures the amount of the award by the amount of tuition. Effective July 12, 1999, section 17:3048:1.A.(2) was amended to provide that a qualified student "shall be

awarded by the state an amount determined by the administering agency to equal the tuition charged by the public university . . . ."[2] (Emphasis added.)

Section 17:3048:1.A.(1)(f) directs the administering agency to provide guidelines and procedures directing that when tuition is paid from a source other than the TOPS award, "the award shall be applied by the institution attended by the student toward payment of expenses other than tuition which are described in the term "cost of attendance" as that term is defined in 20 U.S.C. 1087(II) [sic], as amended, for the purpose of qualifying the student or his parent or guardian for the federal income tax credits provided for under 26 U.S.C. 25A." (Emphasis added.)

The term "cost of attendance" is defined in 20 U.S.C. § 1087*ll*(1) - (3) to include tuition, fees, costs for rental or purchase of any equipment, materials, or supplies required of all students in the same course of study. The term also encompasses allowances for books, supplies, transportation, and miscellaneous personal expenses (including a computer rental or purchase) and for room and board.

As noted above, a TOPS award may be paid by the administering agency, on behalf of the student, to the institution at which an individual is enrolled. However, Louisiana law alternatively provides that a student may delay acceptance of the TOPS award until after the student (if he is not claimed as a dependent of a parent or guardian on a federal income tax return), or his parent or guardian (if he is so claimed as a dependent), files his federal income tax return. Section 17:3048:1.K.(3)(a)(i). The amount of a delayed award depends on whether a § 25A education tax credit was claimed on the relevant federal income tax return. If the student delays the acceptance of his award and the student, parent, or guardian does not claim a § 25A education tax credit on his federal tax return, the administering agency shall pay directly to the student the amount of the award the agency would otherwise have paid to the institution on the student's behalf. Section 17:3048:1.K.(3)(a)(iii).

However, if the student delays the acceptance of his award and the student, parent, or guardian does claim a § 25A education tax credit for money spent on the student's tuition at a post-secondary institution, then the amount awarded by the state will be affected. Louisiana provides in this circumstance that: "[T]he administering agency shall pay directly to the student an amount equal to the amount of the award that would have been paid to the eligible institution on behalf of the student less the amount of the tax credit claimed plus as an incentive for claiming the credit and thus reducing the cost

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2/ 1999 La. Acts No. 777; 1999 La. Acts No. 1302. The amount awarded ordinarily is an amount equal either to the tuition charged by the particular school (if the student attends a public college or university) or to the weighted average of amounts paid by the state for tuition to public colleges and universities (if the student attends a private school). Section 17:3048:1.A.(1)(g)(2).

to the state of this program, an amount equal to twenty-five percent of the amount of the credit claimed."[3] Section 17:3048:1.K(3)(a)(ii).

Any student electing to take a delayed award will receive the award directly and may spend the amount of the award on any of his or her "cost[s] of attendance" (as defined above).

LAW AND ANALYSIS:

1. The § 25A education tax credit.

Section 25A provides for the Hope Scholarship Credit and the Lifetime Learning Credit (collectively referred to as the education tax credit). In general, the education tax credit allows individual taxpayers to claim a nonrefundable tax credit against their federal income tax for the payment of certain post-secondary educational expenses. Assuming the other requirements of § 25A are met, the credit may be claimed if the taxpayer pays “qualified tuition and related expenses” (or alternatively, "qualified expenses') within the meaning of § 25A(f)(1). As you noted, the relationship between such qualified expenses and the TOPS award is crucial to the analysis in this case.

Definition of "Qualified Tuition and Related Expenses" under § 25A.

Section 25A(f)(1)(A) defines "qualified tuition and related expenses" as tuition and fees required for the enrollment or attendance for courses of instruction at an eligible educational institution. Qualified expenses specifically do not include expenses associated with any course or other education involving sports, games, or hobbies, unless that course is part of the degree program.[4] Section 25A(f)(1)(B). Student activity fees, athletic fees, insurance expenses, or other expenses unrelated to the individual’s academic course of instruction are also not included in the definition of "qualified tuition and related expenses." Section 25A(f)(1)(C).

3/ A student, parent, or guardian who pays tuition from non-TOPS sources and who seeks to receive the additional incentive payment must provide the administering agency proof of the amount of the § 25A credit he or she received. Section 17:3048:1.K(b).

4/ Additionally, the proposed regulations provide that the term "qualified tuition and related expenses" does not include any noncredit course, unless the course or other education is part of the student's degree program. In the case of the Lifetime Learning Credit, expenses paid for courses involving sports, games, or hobbies, or for noncredit courses, are allowed only if the course or other instruction was taken by the student to acquire or improve job skills. Prop. Reg. § 1.25A-2(d)(5).

Section 1.25A-2(d)(1) of the proposed regulations restates the statutory definition found in § 25A(f)(1)(A). The proposed regulations then add that except as provided by Prop. Reg. § 1.25A-2(d)(3) (discussed below), the general test used to determine whether a fee is qualified 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." Prop. Reg. § 1.25A-2(d)(2)(i). Fees for books, supplies, and equipment used in a course of study, and fees charged by an educational institution that are not directly used for, or allocated to, an academic course constitute qualified expenses only if the fees must be paid to the institution for the student's enrollment or attendance at said institution. Prop. Reg. § 1.25A-2(d)(2)(ii).

Prop. Reg. § 1.25A-2(d)(3) provides an exception to the general rule that required fees are eligible for the education tax credit. That proposed regulation specifically states that regardless of whether the fee *must* be paid to the institution for enrollment therein, qualified tuition and related expenses do not include the following personal expenses:

- the costs of room and board,
- insurance,
- medical expenses,
- transportation, and
- similar personal, living or family expenses.

Section 1.25A-2(d)(4) of the proposed regulations describes the treatment of a required comprehensive fee, which typically includes charges for tuition, fees, and some or all the personal expenses listed above. The proposed regulations require educational institutions to make a reasonable allocation between qualified expenses and personal expenses and provide that the portion of the comprehensive fee that is allocable to personal expenses is not a qualified expense.

2. The § 117 exclusion for qualified scholarships.

Section 117(a) of the Code states that gross income does not include any amount received as a "qualified scholarship" by an individual who is a candidate for a degree at an educational institution. Section 117(b)(1) defines a "qualified scholarship" as being any amount received by an individual to the extent the individual establishes that, in accordance with the conditions of the grant, such amount was used for qualified tuition and related expenses. Section 117(b)(2) defines "qualified tuition and related expenses" as (A) tuition and fees required for enrollment or attendance, and as (B) fees, books, supplies, and equipment required for courses of instruction.

Prop. Reg. § 1.117-6(c)(2) repeats and then amplifies the statutory definition of qualified tuition and related expenses as follows (emphasis added):

> In order to be treated as related expenses under this section, the fees, books, supplies, and equipment must be required of all students in the particular course of instruction. Incidental expenses are not considered

> related expenses. Incidental expenses include expenses incurred for room and board, travel, research, clerical help, and equipment and other expenses that are not required for either enrollment or attendance at an educational organization, or in a course of instruction at such educational organization.

Prop. Reg. § 1.117-6(c)(1) provides that a grant may be a qualified scholarship even if the grant does not expressly require that the amounts received be used for tuition and related expenses. However, the proposed regulation also provides that if the grant either specifies that any portion of the grant cannot be used for tuition or related expenses, or designates any portion to be spent on such items as room or board, the amounts so specified or designated are not amounts received as a qualified scholarship.

Prop. Reg. § 1.117-6(e) provides that an individual seeking to exclude from gross income any amount received as a qualified scholarship must maintain records establishing both the amounts used for qualified tuition and related expenses and the total amount of such qualified tuition and related expenses. Upon request, the recipient also must submit documentation concerning the conditions and requirements of the particular grant. Subject to the other rules of § 117, Prop. Reg. § 1.117-6(e) provides that "qualified scholarship amounts are excludable without the need to trace particular grant dollars to particular expenditures for qualified tuition and related expenses."

A grant or award that is not excludable under § 117 must be included in the recipient's gross income under § 61. Generally, under proposed § 1.117-6(a), any amount of a scholarship that is not excludable under § 117 is includable in the gross income of the recipient for the taxable year in which such amount is received, notwithstanding the provisions of § 102 (relating to exclusion from gross income of gifts).

3. The Relationship of §§ 25A and 117: Adjustments to Qualified Tuition and Related Expenses Required Upon Receipt of a Grant or Scholarship.

It is evident from the above discussion that §§ 25A and 117, and their respective proposed regulations, define the term "qualified tuition and related expenses" in substantially the same way. Under both Code sections, the phrase “qualified tuition and related expenses” (or alternatively, "qualified expenses") encompasses tuition, and may include books, supplies, and specified fees. However, qualified expenses do not include several items -- such as expenses for room and board or for transportation -- that may be considered part of the "cost of attendance" under the federal student aid rules.

Not surprisingly, Congress determined that a student should not be entitled to both a credit and an exclusion for the same expenses. To prevent a double tax benefit, § 25A(g)(2)(A) states that before the education tax credit can be calculated, qualified tuition and related expenses shall be reduced by amounts paid for the benefit of an

individual that are allocable to a qualified scholarship excludable from gross income under section 117.[5/] Prop. Reg. § 1.25A-5(c)(1) is to the same effect.

For purposes of this reduction, Prop. Reg. § 1.25A-5(c)(3) creates a default or ordering rule. The proposed regulation states that a scholarship or fellowship grant is considered a "qualified scholarship excludable from income under section 117" unless (emphasis added):

> (i) The grant is reported as income on the taxpayer'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.

The presumption underlying the ordering rule -- that for § 25A purposes a scholarship or fellowship grant is treated as excludable under § 117 unless one of two conditions is met -- is illustrated in Prop. Reg. 1.25A-4, Example (1). The example states that University X charges Student A a total of $8,000 ($3,000 for tuition and $5,000 for room and board) and awards Student A a $2,000 scholarship, the terms of which permit it to be used to pay any of the student's costs of attendance, including room and board. Student A pays the $6,000 balance of her bill from a combination of savings and amounts earned from a summer job. Because Student A does not report any portion of the award in her income (and because the terms of the award do not require it to be used on non-qualified expenses), Student A is treated, for purposes of calculating the education tax credit, as having paid only $1,000 ($3,000 tuition minus $2,000 excludable scholarship) of qualified tuition and related expenses.

4. Federal tax consequences of the Louisiana TOPS Award under §§ 25A and 117.

As noted earlier, prior to being amended in 1999, Louisiana law required that awards made to students under the TOPS program be spent on tuition. As such, the amount of any award was excludable from gross income under § 117 and reduced the amount of qualified expenses eligible for the education tax credit. However, in 1999, the Louisiana legislature amended the TOPS statute for the express purpose of qualifying a student or his parent or guardian for the § 25A credit. The legislature amended the TOPS statute to --

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5/ Section 25A(g)(2)(B) and (C) provides for a similar reduction in the amount of qualified expenses taken into account for the credit in the event an individual receives specified excludable educational assistance allowances or other types of exempt income (other than a gift, bequest, devise, or inheritance excludable from gross income under § 102(a)).

(1) provide that TOPS awards are in an amount equal to tuition (rather than being for tuition);

(2) cause the administering agency to direct the institution that whenever the TOPS award is paid on behalf of the student and the student's tuition is paid from a source other than the TOPS award, the award is to be applied by the educational institution toward payment of those "costs of attendance" other than tuition; and

(3) permit a student to elect to defer receipt of a TOPS award and to spend the amount received on costs of attendance other than tuition and provide that the amount of the award will be reduced if a § 25A credit is claimed.

We view these statutory provisions as terms of the grant and discuss below the effect the Service should give these terms in applying §§ 25A and 117 to award recipients.

Clearly, Louisiana, through (1) and (3), above, changed the TOPS award from one restricted to use for tuition to one that might be used for those costs of attendance that are not qualifying expenses. Were (1) and (3) the only statutory changes, the federal tax consequences would be simple to state: the recipient could exclude the TOPS award under § 117 upon a showing that an amount at least equal to the amount of the award was used for qualifying expenses, but would be required to reduce the qualified expenses available for the § 25A credit by the amount excluded. On the other hand, qualified expenses for credit purposes would not be reduced to the extent the student included the award in income (i.e., elected not to exclude the award under § 117). By broadening the use to which a TOPS award may be put, Louisiana achieved, in (1) and (3), its apparent objective of allowing the award recipients both to claim the § 25A credit and to receive the state-based financial aid represented by the TOPS award.

A more difficult question involves (2), wherein the state's administering agency directs an educational institution to apply a TOPS award to costs of attendance other than tuition in the event the TOPS award is paid on behalf of the student and the student's tuition is paid from a source other than the award. Under proposed § 1.117-6(c)(1), a grant may not be excluded from income if it specifies that any portion of the grant cannot be used for tuition or related expenses, or designates any portion to be spent on such items as room or board. If (2) is such a term, then under § 117 a TOPS grant would not be excludable whenever (2) applies.

We do not believe that, in applying § 25A, the Service should construe (2) as being a term of the grant sufficiently specific to require the grant's inclusion in gross income. First, we believe the Service should view Term (1) (permitting but not requiring use of the award for qualifying expenses) as being the primary grant term. Second, we believe that the direction in (2) reflects an effort to trace a particular source of funds to a particular expenditure through a mere bookkeeping entry, which effort should be disregarded under the proposed § 117 regulations.

Louisiana permits application of each TOPS award either to tuition or to other cost-of-attendance expenses. All awards are made subject to this term. The flexibility thereby gained – that the TOPS award can be applied to qualifying or non-qualifying expenses – does not satisfy the proposed § 1.117-6(c)(1) requirement that the grant's terms preclude use of the funds for qualifying expenses. So far as we are aware, no penalty (such as cancellation of the award) attaches to the award recipient if the institution, contrary to what is suggested by (2), applies the award to qualifying expenses, or if the recipient seeks to exclude the award (which treats the award as an amount used for qualified expenses).[6] Under these circumstances, it is difficult to say that the terms of the grant preclude applying the award amount to qualified expenses. Instead, we believe the Service should construe Louisiana's permission to apply the award either to qualifying or non-qualifying expenses as the term of primary significance in applying § 117. Louisiana's direction to the administrative agency to provide policies and procedures on directing institutions how to apply TOPS awards in certain circumstances is not a grant term that is a sufficiently specific restriction to non-qualifying expenditures to satisfy the provisions of the proposed regulations.

Second, our interpretation of (2) above is bolstered by proposed § 1.117-6(e), which provides that an award may be excluded without tracing particular grant dollars to particular expenditures for qualified tuition and related expenses. We think that Louisiana's direction to the institution described in (2) above is simply another way of tracing the grant, in this case to expenditures that are not consistent with exclusion. But tracing a particular award to non-qualifying expenditures is not the test under the proposed regulations: rather, the test requires the terms of the grant to preclude expenditure payment of tuition with the grant. As we discussed above, we do not believe the current terms governing TOPS awards restrict the award to non-qualifying expenditures. If tracing is not necessary to claim an exclusion, mere tracing should be inadequate to defeat an exclusion claimed by the student.

Under the terms of the grant as we construe them, therefore, the Service should give effect to Louisiana's changes under (1), above, which permit the award to be used for either qualifying or non-qualifying expenses. Under this interpretation, the exclusion of the grant is determined by the tax reporting of the grantee. The Service should not construe (2) above as a term requiring inclusion of the TOPS award in income, even in situations in which it applies, if the recipient's tax reporting is to the contrary and entitlement to exclusion under § 117 is otherwise satisfactorily demonstrated. If the student includes the award in income, the award does not reduce qualified expenses for purposes of the education credit. Conversely, if the student properly excludes the award from income pursuant to § 117, qualified expenses must be reduced by the amount of the award for purposes of the education tax credit.

6/ If the student has received multiple awards applicable to tuition, the amount spent on tuition is still the maximum amount of such awards that may be excluded, so our view creates no anomalies in the application of § 117.

We believe the following two scenarios represent likely scenarios you may see if receipt of the TOPS award is not deferred.

1. A student at a private Louisiana college receives a TOPS award, directs that the award be applied toward qualified expenses, and pays the balance of the tuition owing from his own funds. The student may exclude the TOPS award (up to the amount of tuition paid) from his gross income under § 117, but must subtract the amount of the excluded award from the total amount of qualified expenses paid in calculating the § 25A education tax credit.[7]

2. A student receives a TOPS award, pays qualified expenses from her own funds, and directs (consistent with the TOPS direction) that the entire amount of the TOPS award be applied toward cost-of-attendance expenses other than qualified expenses. The student may then either include the amount of the TOPS award in her gross income, or exclude it (up to the amount of tuition paid) under § 117. Whether she needs to reduce her qualified expenses by the TOPS award amount when calculating the § 25A education tax credit depends on whether she chose to exclude the award under § 117.

As we note in passing in the next section, these results are unchanged if the award is received after the close of the year in which tuition is paid and before the filing of the return for that year.

5. Recapture of a delayed TOPS award.

As noted earlier, La. Rev. Stat. § 17:3048.1K(3), encourages TOPS recipients to defer receipt of their award so that a § 25A credit may be claimed. After the subject tax return is filed, the state statute provides that the recipient will be paid the award less the amount of the § 25A credit, plus a twenty-five percent incentive amount. We concur in your view that the State of Louisiana is awarding the incentive in the hope that the federal government -- through its allowance of the § 25A credit -- will effectively reduce Louisiana's expenses in the TOPS program. As we believe that Louisiana's deferred receipt approach ordinarily requires award recipients or their parents to recapture the credit previously taken, we also concur in your recommendation that the examination functions of the Internal Revenue Service should take the steps necessary to assure that the § 25A credits taken are properly recaptured in the subsequent year.

7/ A student enrolled at a public Louisiana college and receiving a TOPS award must make the same calculation as the student enrolled at a private school. However, because a TOPS award is more likely to cover the full amount of tuition at a public than at a private college, the student at a public college is less likely than his private-college counterpart to have "excess" tuition on which to claim a credit.

The proposed regulations provide for determining credits after reducing qualified expenses by refunds or excludable tuition assistance received during the taxable year or in the following taxable year before filing of a return for the year in which the qualifying expenses were paid. The proposed regulations also provide rules for recapturing credits taken in prior years when either a refund of qualified expenses paid, or excludable tuition assistance attributable to the expenses of the prior year, is received. The recapture is effected by adding the recaptured credit to the taxes due for the year the refund or assistance is received.

Two provisions, proposed § 1.25A-5(f)(3) and (f)(4), are relevant to the TOPS program of deferring the payment of the award until after a § 25A credit is claimed.

Proposed § 1.25A-5(f)(4) provides that, if a taxpayer (or the taxpayer's spouse or claimed dependent) receives in a taxable year (refund year), after filing the federal income tax return for a prior taxable year, any excludable educational assistance for the qualified tuition and related expenses paid during the prior taxable year, any education credit claimed for the prior taxable year is subject to recapture as provided in § 1.25A-5(f)(3).

Proposed § 1.25A-5(f)(3)(ii) provides that 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 first 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 (resulting in redetermined qualified expenses), and then 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. 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. Proposed § 1.25A(f)(3)(i) provides that the recapture amount increases the tax imposed by chapter 1 of the Internal Revenue Code (the income tax) for the refund year.

We present scenarios you may see if receipt of the TOPS award is deferred and if the recipient does, or does not, seek to receive the incentive payment for claiming a § 25A credit.

3. *Receiving Louisiana's incentive payment.* A student who is entitled to receive a TOPS award in Year 1 defers receipt until Year 2, pays (or his or her parent pays) qualifying expenses in Year 1 from his or her own funds, claims (or his parent claims) a § 25A credit for qualifying expenses paid in Year 1, then receives in Year 2 the deferred TOPS award (reduced by the credit claimed but increased by the additional amount) after the filing of the tax return for Year 1 on which is claimed the § 25A credit for the qualifying expenses paid. The student chooses to demonstrate, in accordance with § 117, that the award is excludable based on the qualifying expenses paid in Year 1 (since no portion must be used to pay non-qualifying expenses). Therefore, the person claiming the credit is

treated as having received a refund of qualifying expenses paid in Year 1, must recompute the Year 1 § 25A credit claimed, and must include the excess credit claimed as tax on the return for the year of the receipt of the refund (in this case, Year 2, the year of receipt of the scholarship excluded under § 117).

4. *Receiving full TOPS award on deferred basis.* A student who is entitled to a TOPS award in Year 1 defers receipt until Year 2, pays (or his or her parent pays) qualifying expenses in Year 1 from his or her own funds, then receives the full amount of the TOPS award in Year 2 after the filing of the Year 1 tax return on which the § 25A credit for the tuition paid in Year 1 would be claimed (if proper), thereby declining to receive the incentive payment. If a Year 1 § 25A credit is claimed with respect to the qualifying expenses paid (apparently contrary to Louisiana's terms for deferred payment of the full amount of the award) and the student claims that the TOPS award received is excluded from income under § 117 (based on the payment of Year 1 qualifying expenses), the Year 1 § 25A credit must be recomputed and the excess, recaptured in Year 2. If the TOPS award is included in the student's income, there is no need to recompute the § 25A credit.

Thus, if any § 25A credit is taken for Year 1 in scenario 3 or 4 above, it would be subject to recapture upon the deferred receipt of a TOPS award in Year 2 that is excluded from income based upon payment of the Year 1 qualifying expenses. As noted above, the recapture is determined by treating the TOPS amount received and excluded from income as a refund of qualified expenses paid in recomputing the Year 1 credit, and reporting as tax in the year the award is received (Year 2) the amount by which the Year 1 credit taken exceeds the Year 1 recomputed credit.

You may wish to suggest that the appropriate Service officials undertake efforts to convey the Service's views to Louisiana residents both in pre-filing and post-filing efforts.

If we may be of further assistance, including upon publication of the final regulations, please telephone this office at (202) 622-4920.