17

Tax Credits

Goal: This unit defines tax credits exploring their value and offering examples of some of the most commonly used tax credits. Tax credits are an important part of the asset-building tool kit.

RESOURCE:

Year-end Tax Planning Checklist
from the Financial Planning Association

www.fpanet.org/toolsresources/articlesbookschecklists/checklists/taxes/yearendtaxplanningchecklist/

Tax deductions and tax credits are two kinds of benefits paid to workers/taxpayers through the tax system. A tax deduction is an amount of money that reduces the amount of your income that's subject to taxation. A tax credit is an amount of money that reduces your tax bill. Here's an example that illustrates a tax deduction and a tax credit:

Maria makes $50,000 per year and her income is subject to a tax rate of 20%. The quantity 20% in decimal form is .20. So to figure out what she'd owe in taxes, we'd multiply .20 x $50,000 and end up with Maria owing $10,000 in taxes. Now let's assume that Maria qualifies for a $1000 deduction. This would mean that her income is reduced by $1000 leaving her with an income subject to taxation of $49,000. Twenty percent (.20) of $49.000 is $9800 and $49,000 - $9800 = $39,200. So the deduction has reduced Maria's tax bill by $200.00 and left her with an after tax income of a little over $39,000.

Now assume that Maria doesn't qualify for a deduction of $1000 but is eligible for a tax credit of $1000. As we saw before, her tax bill would be $10,000. But because she has a tax credit of $1000, this amount should be subtracted from the amount she owes in taxes. So instead of owing the federal government $10,000, she'd owe it only $9000. That is because under the tax credit, Maria's tax bill would be $800 less than it would be under the deduction, Maria's after tax income would increase by $800 from $39,200 to $40,000. So Maria would get more out of the tax credit than she would out of the tax deduction.

Tax Credits provide better value than tax deductions

Financially, a tax credit is generally more valuable than an equivalent tax deduction. As demonstrated in the case example, a tax credit will always result in a higher net income than a tax deduction will.

While most tax credits have traditionally been available to, and benefited, middle class or wealthy families, the government has created tax credits targeting low-income households. Asset building as a strategy to help low-income people save money has grown in popularity over the past couple of decades.

Tax credit programs can supplement low-income earners and public benefit recipients.

Tax credit programs are available to supplement low-income wage earners but some are also available to public benefit recipients. Tax credits reflect family size and are phased out above a specified amount of income. Tax credits are paid in a lump sum similar to the ordinary tax rebate following tax season. The annual nature of the refund means these funds are not available for immediate daily living expenses. However, the lump sum payment can be used for savings, educational costs, to pay off debt, or for costly purchases such a refrigerator, television, computer, or car.

Historically, most asset-building policies were based upon regressive taxes. A regressive tax is one where the average tax rate decreases as taxable income increases. A progressive tax is one where the average tax rate increases as taxable income increases. For example, the tax on clothing or other goods means low-income people pay a greater proportion of their income for the same items as people with greater economic resources. Income taxes are an example of a progressive tax, whereby people with higher incomes pay more.

The *Assets & Opportunity Scorecard* reviews asset building policies and strategies state by state. See how your state compares to other states regarding policies to assist low-income people access greater opportunities and increase their assets.

RESOURCE:
Assets & Opportunity Scorecard
http://scorecard.cfed.org/

Department of Consumer Affairs
Office of Financial Empowerment

RESOURCE:
Tax Credit Campaign from NYC's Office of Financial Empowerment
www.nyc.gov/html/ofe/html/poverty/taxcredit.shtml

Practitioners can refer clients to the Volunteer Income Tax Assistance Program (VITA). VITA is coordinated by state Departments of Revenue in partnership with community organizations and offers free tax advice and assistance to low-income individuals who might otherwise pay for commercial tax assistance. VITA volunteers are located in convenient community sites such as public libraries, schools, neighborhood centers, and shopping malls. The New York City Office of Consumer Affairs "Tax Credit Campaign" has information about tax credit campaigns and VITA tax preparation sites.

A. Earned Income Tax Credit (EITC)[1] is perhaps the most well-known tax credit. The EITC provides tax-refunds for individuals and families with low-incomes. There is a complicated qualification process. A tax specialist should be consulted. EITC refunds can be directly deposited into checking accounts.

RESOURCE:
Ten Things to Know about the Child and Dependent Care Credit from the IRS
www.irs.gov/newsroom/article/0,,id=106189,00.html

B. Child Care Tax Credit. The Child Care Tax Credit is a federal, state, and New York City tax credit that assists families with the cost of child care. Eligibility requirements for the New York City Child Care Tax Credit (CCTC) include children living in the household who are up to (but not including) age four. Parents must earn less than $30,000 to claim the NYC CCTC. In 2011, families could receive a maximum of $1,733. Federal and State Child Care refunds are also available for income eligible families.

C. Energy Tax Credit. Fuel-efficient vehicles and energy-efficient appliances and products provide many benefits such as better gas mileage, resulting in lower gasoline costs, fewer emissions, and lower energy bills, increased indoor comfort, and reduced air pollution. The government provides this incentive to encourage people to conserve energy.

RESOURCE:

Energy Efficiency Tax Credit Information
from the US Department of Energy

www.energysavers.gov/financial/70010.html

D. Home Energy Efficiency Improvement Tax Credit. Consumers who purchase and install specific products, such as energy-efficient windows, insulation, doors, roofs, and heating and cooling equipment in existing homes can receive a tax credit for 30% of the cost, up to $1,500, for improvements "placed in service" from 2009. There is no dollar limit on the credit for most types of property. If your credit is more than the tax you owe, you can carry forward the unused portion of this credit to next year's tax return. The credit will be available through 2016.

E. Residential Renewable Energy Tax Credit. Consumers who install solar energy systems (including solar water heating and solar electric systems), small wind systems, geothermal heat pumps, and residential fuel cell and micro-turbine systems can receive a 30 percent tax credit for systems placed in service before December 31, 2016; the previous tax credit cap no longer applies.

F. Alternative Motor Vehicle Credit. Individuals and businesses who buy a new qualifying vehicle that was purchased or placed in service on before January 1, 2006 may qualify for this credit. Hybrid vehicles have drive trains powered by both an internal combustion engine and a rechargeable battery. Many currently available hybrid vehicles may qualify for the tax credit.

G. Education Tax Credits. Education tax credits help to offset the costs of education. The American Opportunity (Hope Credit extended) and the Lifetime Learning Credit are education credits that a person can subtract in full from the federal income tax, not just deduct from taxable income.

1. The American Opportunity Credit. This credit helps parents and students to pay part of the cost of the first four years of college. Eligible taxpayers may qualify for the maximum annual credit of $2,500 per student. Generally, 40 percent of the credit is refundable, which means that families might receive up to $1,000, even if they do not owe taxes.

2. The Hope Credit. This credit helps students and parents to pay part of the cost of the first two years of college.

3. The Lifetime Learning Credit. This credit helps to pay for undergraduate, graduate and professional degree courses – including courses to improve job skills – regardless of the number of years in the program.

4. **Tuition and Fees Deduction.** Students and their parents may be able to deduct qualified college tuition and related expenses of up to $4,000. This deduction is an adjustment to income, which means the deduction will reduce the amount of income subject to tax. The Tuition and Fees Deduction may be beneficial to families that do not qualify for the American Opportunity, Hope or Lifetime Learning credits.

One cannot claim the American Opportunity and the Hope and Lifetime Learning Credits for the same student in the same year. Nor can individuals claim any of the tax credits if they also claim tuition and fees deduction for the same student in the same year. To qualify for an education credit, a person must pay post-secondary tuition and certain related expenses for themselves, their spouse or their dependent. The credit may be claimed by the parent or the student, but not by both. Students who are claimed as a dependent cannot claim the credit.

Case Example One: Earned Income Tax Credit

Mr. and Ms. W. a young Arab-American couple, have two small children. They both work part-time and are completing college in the evenings. Their combined annual income is $47,000, and they have trouble making ends meet for their family. Their budget is very tight and they have no wiggle room for "extras." In a weekly session with their social worker, they shared their financial concerns.

For Discussion:

1. Find out if this family would be eligible for the Earned Income Tax Credit.

2. What role (see Part A, Unit Two) is the worker using in focusing on Earned Income Tax Credit in her work with the W. family?

3. Do you think the social worker is "crossing the line" and becoming a financial counselor by informing the W. family about the EITC?

NOTES
UNIT SEVENTEEN

1. Tax Credit Campaign: Earned Income Tax Credit. The NYC Department of Consumer Affairs Office of Financial Empowerment. Retrieved from http://www.nyc.gov/html/ofe/html/poverty/eitc.shtml