Federal Income Tax Credits

by Sophia

WHAT'S COVERED

In this lesson, you will learn how federal income tax credits for education, health insurance, and households with children can help to lower income taxes. You will also review the benefits of taking care of your taxes. Specifically, this lesson will cover:

1. Understanding Tax Credits

Would you file a tax return if you knew that you would receive more money back (in the form of a tax refund) than what you had paid in taxes all year? For some people, that is exactly what happens. Although none of the tax brackets have a negative tax rate, negative effective tax rates do occur.

1a. Negative Effective Tax Rates

Negative effective tax rates result when refundable tax credits exceed an individual's total tax. A **tax credit** is a dollar-for-dollar reduction in an assessed tax liability. When a tax credit is refundable, it is possible for a taxpayer to get back more money than he or she paid in taxes. Essentially, a negative effective tax rate works out as a benefit to the taxpayer. The following illustration shows how tax credits work to reduce a person's tax liability.

TERMS TO KNOW

Negative Effective Tax Rate
The result when refundable tax credits exceed an individual's total tax.

Tax Credit
A dollar-for-dollar reduction in an assessed tax liability.

1b. Value of Tax Credits

As noted previously, tax credits reduce a tax filer's assessed income tax dollar for dollar. What this means is that a $1,000 tax credit is more valuable than a $1,000 deduction.

- The tax savings from the tax credit is $1,000.
- The tax savings from the deduction is equal to $1,000 multiplied by the marginal tax rate. As such, the resulting tax savings will always be less than $1,000.

The following table compares a $1,000 FOR AGI deduction and a $1,000 refundable tax credit for a single taxpayer with income of $20,000. As shown, the difference is that the $1,000 tax credit results in a $200 tax refund, whereas the $1,000 FOR AGI deduction simply reduces taxable income (the taxpayer still owes $700 in tax).

Table: Comparison of Tax Deduction and Refundable Tax Credit

	Example of $1,000 FOR AGI Deduction	Example of $1,000 Refundable Credit
Gross income	$20,000	$20,000
Deduction FOR AGI	– 1,000	– 0
AGI	$19,000	$20,000
Standard deduction	– 12,000	– 12,000
Taxable income	$7,000	$8,000
Tax rate (10% bracket)	× 10%	× 10%
Tax	$700	$800
Refundable tax credit	– 0	– 1,000
Net tax owed	$700	
Net tax refund		$200
Net additional tax savings resulting from the credit		**$900**

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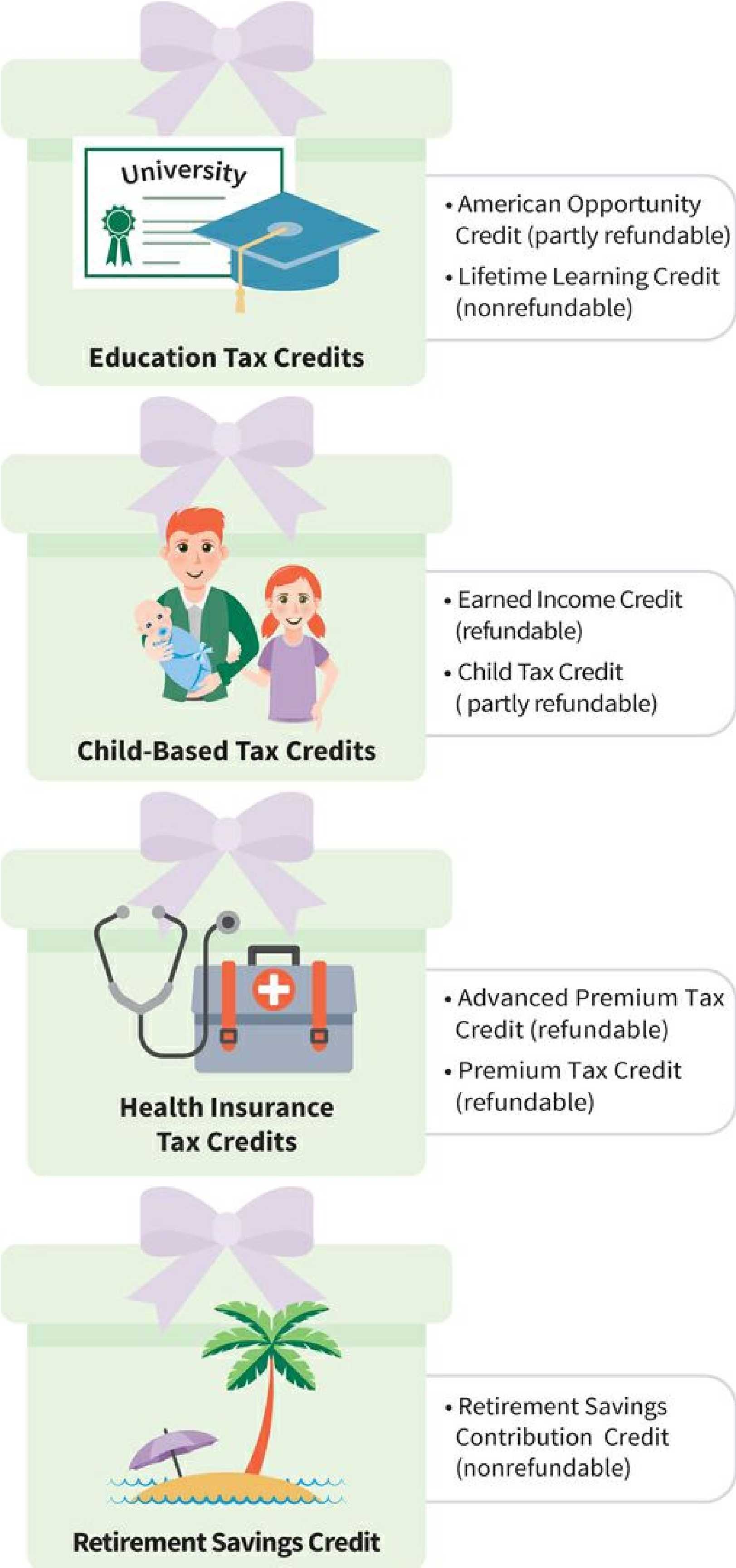
2. Common Federal Income Tax Credits

Tax credits come in two forms:

1. **Refundable tax credits** can reduce a household's assessed tax below zero, resulting in the federal government paying the household money when taxes are filed.
2. **Nonrefundable tax credits** can reduce a household's assessed tax to zero but cannot make it negative (where the federal government owes a taxpayer money).

Several different types of refundable and nonrefundable tax credits are available to individuals and families. The illustration below shows four of the most popular categories of tax credits.



DID YOU KNOW

Congress offers most federal income tax credits as an incentive to encourage individuals to take action that will benefit them, as well as the overall economy, in the long run.

TERMS TO KNOW

Refundable Tax Credit

A tax credit that reduces the amount of tax someone must pay. If the credit exceeds the tax liability, the difference can also be received directly by the taxpayer.

Nonrefundable Tax Credit

Tax credits that can reduce an individual's assessed tax to zero but cannot make it negative (where the federal government owes the taxpayer money).

2a. Education Tax Credits

Because the government values your education, Congress has enacted tax credits so that you don't have to pay as much in taxes while you are going to school. In fact, you might get some money back from the government when going to school. One of these education tax credits is the American Opportunity Tax Credit. This is a partly refundable tax credit that is available to whomever claims the student as a dependent on their tax return.

The Lifetime Learning Credit is also available to taxpayers who do not qualify for the American Opportunity Credit.

2b. Tax Credits for Dependent Children

If you have a child or are thinking about having children in the future, there are three refundable credits that you should know about.

1. The Earned Income Tax Credit is a refundable credit designed to reward work and boost the earnings of low-income workers.
2. The Child Tax Credit provides a maximum $2,000 nonrefundable credit per qualifying child in the household. Up to $1,400 of the Child Tax Credit is refundable.
3. A dependent credit can be claimed for qualifying dependents who are not eligible for the Child Tax Credit. This dependent credit is a nonrefundable $500 credit per qualifying dependent.

2c. Health Insurance Tax Credits

Congress offers two credits designed to help individuals and households avoid potentially catastrophic medical costs by purchasing health insurance.

1. The Premium Tax Credit is a refundable credit available to taxpayers who purchase a health insurance plan through a qualified state or federal exchange and who do not have the option to purchase health insurance coverage through their employer or through a family member's health insurance policy. The Premium Tax Credit is designed to make health insurance more affordable.
2. The Advanced Premium Tax Credit can be used during the entire year to lower the cost of monthly premiums on health insurance plans that are purchased through a state or federal health insurance exchange. If a taxpayer chooses to receive the Advanced Premium Tax Credit, the amount of the credit will be estimated based on what the taxpayer thinks he or she will earn during the coming year. At the end of the year, the difference between this estimated Advanced Premium Tax Credit and the actual Premium Tax Credit is calculated. At that time, the taxpayer may receive an additional refund or be required to repay the excess Advanced Premium Tax Credit received.

2d. Tax Credits for Retirement Savings Contributions

Congress wants you to be financially successful. As a result, Congress set up a plan to help some taxpayers lower taxes through the Retirement Savings Contribution Credit. The Retirement Savings Contribution Credit is a nonrefundable tax credit of up to $1,000 for taxpayers with modest incomes who contribute up to $2,000 to their own retirement savings accounts.

Note that this credit is not available to full-time students. This credit also phases out relatively quickly as income rises.

2e. Excess Federal Income Tax Withholdings

Perhaps the most common refundable item for taxpayers is based on overpaying federal income taxes during the year.

- When you start a job, you need to complete several forms for your employer.
- One of these documents is a W-4 form, shown below.
- Based on this form, federal (and sometimes state) income taxes are automatically withheld from each of your paychecks.

Separate here and give Form W-4 to your employer. Keep the top part for your records.

Form **W-4**
Department of the Treasury
Internal Revenue Service

Employee's Withholding Allowance Certificate

▶ Whether you are entitled to claim a certain number of allowances or exemption from withholding is subject to review by the IRS. Your employer may be required to send a copy of this form to the IRS.

1 Your first name and middle initial | Last name | 2 Your social security number

Home address (number and street or rural route) | 3 ☐ Single ☐ Married ☐ Married, but withhold at higher Single rate.
Note: If married, but legally separated, or spouse is a nonresident alien, check the "Single" box.

City or town, state, and ZIP code | 4 If your last name differs from that shown on your social security card, check here. You must call 1-800-772-1213 for a replacement card. ▶ ☐

5 Total number of allowances you are claiming (from line H above or from the applicable worksheet on page 2) | 5
6 Additional amount, if any, you want withheld from each paycheck . . . . | 6 $
7 I claim exemption from withholding, and I certify that I meet **both** of the following conditions for exemption.
• Last year I had a right to a refund of all federal income tax withheld because I had no tax liability, and
• This year I expect a refund of all federal income tax withheld beacuse I expect to have no tax liability.
If you meet both conditions, write "Exempt" here . . . . ▶ | 7

Under penalties of perjury, I declare that I have examined this certificate and, to the best of my knowledge and belief, it is true, correct, and complete.
Employee's signature
(This form is not valid unless you sign it.) ▶ Date ▶

8 Employer's name and address (Employer: Complete lines 8 and 10 only if sending to the IRS.) | 9 Office code (optional) | 10 Employer identification number (EIN)

For Privacy Act and Paperwork Reduction Act Notice, see page 2. Cat. No. 10220Q Form **W-4**

When you complete your Form 1040 (or comparable tax form), you may find that you qualify for a tax refund as a result of excess federal income tax withholdings. This happens when you have had too much in taxes taken out of your paychecks during the year.

HINT

Many individuals adjust their allowances from one year to the next depending on their personal circumstances. Your W-4 form can be easily changed by contacting your employer's human resources department.

3. Importance of Filing a Tax Return

Many people wrongly assume that they do not need to file a tax return because their income is "too low." Although it is true that many individuals with modest incomes are not legally obligated to file a tax return because they don't owe any taxes, these same individuals may miss out on claiming large refunds if they do not file a tax return. In general, if your standard deduction is more than your gross income, then you are not *required* to file a federal income tax return. However, as you have learned throughout this topic, you may be eligible for a significant refund resulting from excess taxes withheld from your paycheck, the American Opportunity Credit, or other refundable credits.

If you have questions or concerns about your rights as a taxpayer, you can contact the Taxpayer Advocate Service.

By practicing your productivity skill alongside your agility skill , you can not only face tax season without fear but also plan and adapt your finances to conquer your financial future.

TRY IT

Juan is attending school full-time and working part-time at a grocery store. Juan contributes $25 a month to a retirement savings plan at work. He earned $15,000 this past year and paid $5,000 for tuition, fees, and books. Juan lives with a roommate and takes out student loans to make ends meet.

Does Juan need to file a tax return? +

Juan is required to file a tax return because his gross income is greater than his standard deduction.

What advice do you have for Juan regarding his tax situation? +

Juan may qualify for the American Opportunity Credit if he is still within the first 4 years of his college education. Although it is great that Juan is saving for retirement (his contributions to his retirement plan will lower his gross income), he will not qualify for the Retirement Savings Contribution Credit because he is a full-time student.

SUMMARY

Understanding tax credits can help keep more of your financial earnings in your pocket. It can also help you pivot if needed to keep you on a path of productivity. In this lesson, you learned the **value** of the most **common federal income tax credits**:

- **Education tax credits** are one way the government shows they value continuing education.
- **Tax credits for dependent children** help parents provide the best care for their kids.
- **Health insurance tax credits** help households avoid catastrophic medical costs.
- **Tax credits for retirement savings contributions** help to support your financial goals.
- **Excess federal income tax withholdings** result from overpaying federal taxes during a given year.

It's **important to file a tax return** to take advantage of these tax credits. As a taxpayer, you might even discover that the government owes you money based on a **negative effective tax rate**.

TERMS TO KNOW

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