CHAPTER 6 Credits & Special Taxes

- Child tax credit
- Earned income credit; child/dependent care credit
- Education credits; foreign tax credit
- Adoption credits
- Basic individual credits for energy efficiency
- Understand basic AMT calculations
- Unearned income taxation for minor children
- Married taxpayers residing in community property states

Credits and Deductions

- A credit is a direct reduction in tax liability
  - Credits are used to target certain groups for tax benefit
  - Provide equal benefit to all taxpayers
- A deduction is a reduction of taxable income
  - Reduces tax liability in the amount of (deduction x tax rate)
  - Provides more benefit to higher income taxpayers

Child Tax Credit

- Provides tax relief through a credit to taxpayers with children
  - Credit for each child under age 17 claimed as a dependent and meeting definition of "qualifying child"

- Credit is $1,000 per child
  - Credit begins phasing out when
    - AGI > $110,000 (MFJ)
    - AGI > $ 75,000 (HH, S)
    - AGI > $ 55,000 (MFS)

Phased out $50 for each $1,000 (or part thereof) that AGI exceeds threshold

Child Tax Credit Example

Example

Kendra and Nguyen are taxpayers with children ages 19, 10, and 3. Their AGI is $113,200 and they file jointly.   What is their Child Tax Credit, assuming all of their children are ‘qualifying children?’

Solution

Example

Kendra and Nguyen are taxpayers with children ages 19, 10, and 3. Their AGI is $113,200 and they file jointly. What is their Child Tax Credit, assuming all of their children are 'qualifying children?'

Solution

AGI exceeds threshold, therefore must figure phase-out

($113,200 - $110,000) / $1,000 = 3.2

Round 3.2 up to 4

(4 x $50) = $200 reduction

Child Tax Credit = ($1,000 X 2) - $200 = $1,800

Note: Only the two youngest qualify for the credit

Earned Income Credit (EIC)

- Refundable credit
  - Serves as "negative" income tax
  - Can get refund even if have no tax liability
- Taxpayer may get EIC, even without kids
  - Taxpayer must be between ages 25 and 65 and not claimed as another taxpayer's dependent
  - "Disqualified income" (certain types of investment income) must be less than $3,350
- Taxpayer(s) with children can receive EIC
  - If child meets definition of "qualifying child"
  - Single or married taxpayers (MFJ only)
  - Earned income meets certain guidelines

To Calculate EIC

- Use EIC tables to calculate or ask IRS to figure for you on Schedule EIC
  - Appendix B provides EIC
  - Compare to results on Worksheet A (on page 6-4) and take smaller of the two credits
  - Preparers must submit “due diligence” checklist
- EIC is reported on page 2 of 1040
  - *Question*: What is different about how this credit is reported on the 1040 compared to other credits?
  - *Answer:* It acts like a payment of tax and therefore taxpayer can receive refund, even if no tax is due

Child & Dependent Care Credit

- Gives tax relief to working parents who must provide childcare for dependents
  - Dependent must be under age 13 or
  - Spouse or dependent who cannot care for themselves
- If child's parents are divorced, child need not be dependent of taxpayer claiming credit if he/she lives more than 50% of year with that parent
- Multiply *qualifying care costs* (see next slide) by an applicable percentage, based on AGI
  - From 35% down to 20%
  - Credit percentages found on Table 6.1 on page 6-5

Child & Dependent Care Credit

- Determine qualifying expenses
  - In-home and out-of-home care
  - Day camps qualify, but not overnight camps
    - Camp must be focused on fun/games, not education
- Limited to the lesser of
  - Earned income of lowest earning spouse*

    or
  - $3,000 (1 dependent) or $6,000 (2+ dependents), reduced by any amounts reimbursed by employer
- Must include taxpayer ID number of caregiver

If spouse is full time student, count him/her as earning $250/month (1 dependent) or $500/month (2+ dependents)

Dependent Care Credit Example

Example

Joanne has salary of $58,400 and investment income of $2,100. Lou, her spouse, is a full-time student for 12 months/year. They have three children under 13 and total daycare costs of $12,800. What is their Child and Dependent Care Credit? How would this change if Lou is not a student and works part-time, earning $3,000, and Joanne received $2,200 of employer-provided dependent care assistance?

Solution

Example

Joanne has salary of $58,400 and investment income of $2,100. Lou, her spouse, is a full-time student for 12 months/year. They have three children under 13 and total daycare costs of $12,800. What is their Child and Dependent Care Credit? How would this change if Lou is not a student and works part time, earning $3,000, and Joanne received $2,200 of employer-provided dependent care assistance?

Solution

Qualifying costs are lesser of:

Her earned income $58,400 *or* his earned income $6,000 (imputed at $500 per month) *or* annual daycare bill of $12,800

Multiply by % from Table 6.1 based on AGI ***$6,000 x 20% = $1,200 credit***

If Lou works and Joanne receives assistance, qualifying costs are lesser of:

Her earned income $58,400 *or* his earned income $3,000 *or* net daycare bill $12,800 - $2,200 = $10,600

Multiply by % from Table 6.1 based on new AGI ***$3,000 x 20% = $600 credit***

Affordable Care Act (ACA)

- Also called Obamacare, many provisions have already been implemented in prior years (3.8% net investment income tax, .9% Medicare surtax, etc.)
- Important provisions affecting average taxpayers will phase in during 2014

Individual Shared Responsibility Provision

- Need to show minimum essential coverage (MEC) or pay a ‘penalty tax’ for failure to meet minimum insurance levels
- MEC is 8% of taxpayer’s income, with certain exemptions for hardships (taxpayer files Form 8965)
- Individual shared responsibility is greater of 1% of household income or $95/adult plus $47.50/child (family maximum of $285)

Affordable Care Act (ACA)

Health Insurance Premium Tax Credits

- Eligible taxpayers (requirements on page 6-10) may receive tax credit intended to lower the cost of health care; household income must be 400% above poverty level to be eligible (taxpayers below this are eligible for Medicaid and *not* the credit)
- Use specific tables to compute allowable credit; credit is lesser of actual health care premiums paid or a benchmark premium less the taxpayer's income (see page 6-10 through 6-12 for guidance on how to calculate the premium tax credit)
- Credit can be obtained either at the time of enrollment or when tax return is filed - if actual credit differs from estimated credit, Form 8962 should be filed to reconcile

American Opportunity Credit

- Provides tax relief for qualified higher education expenses
  - Tuition, fees, books and course materials
- Available for each eligible student in first four years of college
  - Eligible students are taxpayer, spouse or dependent
  - Student must be at least 1/2 time for one term during tax year
  - Student must not have felony drug conviction
- Credit = 100% of first $2,000 + (25% of the next $2,000)
  - Maximum credit = $2,500
  - Phased out when AGI > certain levels (see page 6-13)
  - 40% of it is refundable

Note: This credit is the expanded and renamed 'old' HOPE credit

Lifetime Learning Credit (LLC)

- Provides tax relief for education expenses - encourages taxpayers to take courses to acquire or improve job skills
  - Tuition and fees only (not books)
  - Can be used for less than ½ time attendance
  - Not disqualified for felony drug conviction
- Credit = 20% of first $10,000
  - Maximum credit = $2,000 per year
  - Lower AGI phase-outs than American Opportunity Credit
  - May take credit in relation to undergraduate, graduate or professional courses
  - No limit on number of years you may claim LLC

Limitations

- For each student, taxpayer can get only one of the credits
- May take LLC for one student and American Opportunity Credit for another student
- Only the person claiming the dependency exemption can claim a credit
- Cannot claim for sports, games and hobbies, unless the course is part of a degree program
- Must reduce expenses by tax-free scholarships or employer reimbursements

Education Credits Example

Example

Dave and Val (MFJ) have 2 dependent children and have AGI of $72,000. Sean is taking 4 credits (part-time enrollment) at City College of Newark. His tuition and fees are $4,200. Corey is a freshman at Tulane. Her tuition and fees are $39,200. What amounts may Dave and Val claim as education credits?

Solution

Example

Dave and Val (MFJ) have 2 dependent children and have AGI of $72,000. Sean is taking 4 credits (part time enrollment) at City College of Newark. His tuition and fees are $4,200. Corey is a freshman at Tulane. Her tuition and fees are $39,200. What amounts may Dave and Val claim as education credits, assuming no scholarships?

Solution

Val and Dave may take $3,340 in total education credits**.** Their AGI is below the phase-out limits for both credits, so they get the full amount.

Sean may not take the American Opportunity Credit because he is not enrolled half time. Therefore (20%)($4,200) = *$840 Lifetime Learning credit*

Corey, as a freshman, qualifies for the American Opportunity Credit. (100%)($2,000) + (25%)($2,000) = *$2,500 American Opportunity credit*

Foreign Tax Credit

- U.S. taxpayers are allowed foreign tax credit on income earned in foreign country and subject to income taxes in that country
  - Mostly seen on dividends on foreign stock investments
  - Reported on Form 1116
- Provides relief from double taxation on money generated from foreign sources
  - Maximum credit is amount paid to foreign governments
  - But limited to:

$$\frac{\textit{Net foreign income}}{\textit{U.S. taxable income}} \times \text{U.S. tax liability before credit}$$

Foreign Tax Credit Example

Example

Joe Steele had $200,000 income from U.S. and $100,000 income from employment in Lithuania. He paid $40,000 in Lithuanian taxes. Assume his U.S. tax liability is $85,069; what is Joe's foreign tax credit for the current year?

Solution

Example

Joe Steele had $200,000 income from U.S. and $100,000 income from employment in Lithuania. He paid $40,000 in Lithuanian taxes. Assume his U.S. tax liability is $85,069; what is Joe's foreign tax credit for the current year?

Solution

Maximum Foreign Tax Credit is the $40,000 paid, but limited to: ($100,000/$300,000) x $85,069 = $28,356 credit

Carry back (one year) or forward (ten years) the unused portion: ($40,000 - $28,356) = $11,644

Adoption Credit

- IRS provides a credit as relief to taxpayers who pay adoption expenses and are married filing jointly
- Credit is amount spent up to $13,190 per adoption
  - Adoption credit begins to phase out when AGI > $197,880
  - Different rules if pay expenses over more than one year or if foreign adoption or special needs child
- Qualified adoption expenses include court costs, legal fees, travel, etc.
- Unused credits can be carried over for up to five years

Employer-Provided Adoption Assistance

- If an employer pays qualified adoption expenses on behalf of a taxpayer
  - Employee may exclude amounts paid by employer
  - Must occur under adoption assistance program
- Taxpayer may claim adoption credit and adoption exclusion for same adoption
  - But cannot claim both credit and exclusion for the same expenses
- The total amount excludable per child is limited to $12,190 (subject to phase out)

Adoption Credit Example

Example

Blue and Sarah pay $5,193 for an attorney and a trip to Montgomery, AL (considered qualified adoption expenses) in the current year for adoption of a domestic qualified child. Their AGI = $180,500. What is their adoption credit for 2014?

Solution

Example

Blue and Sarah pay $5,193 for an attorney and a trip to Montgomery, AL (considered qualified adoption expenses) in the current year for adoption of a domestic qualified child. Their AGI = $180,500. What is their adoption credit for 2014?

Solution

Their allowable adoption credit is the full $5,193 (as their AGI is not over the phase-out threshold).

Overview of Major Energy Credits

- In 2014, two major credits designed to encourage individuals to utilize energy-efficient products
  - Plug-in Electric Vehicle Credit
  - Credit for Residential Energy-Efficient Property (REEP)

Check out fueleconomy.gov for more information on federal and state electric vehicle tax incentives

Energy-Efficient Vehicles Credit

- Credit for purchase of hybrid gas-electric vehicles
  - Amounts vary, based on combination of weight and kilowatt hour of traction battery capacity (between $2,500 - $7,500)
  - Credit phases out for each car manufacturer when they hit 200,000 cars sold
  - Allowed for Chevy Volt, Nissan Leaf, Tesla Model S and numerous other electric vehicles

Residential Energy-Efficiency Property (REEP) Credit

- Credit for alternative energy expenditures installed at taxpayer's primary or secondary residence
  - 30% credit for qualified installation of solar, wind or ground source geothermal heat pumps
  - Can't get credit for heating swimming pool or hot tub
- Different credits allowed for fuel cell property
- Intent is to aid solar/wind industries, while encouraging individuals to use alternative energy

Myriad of Other Credits

- Numerous tax credits available in addition to ones listed in slides, including:
  - *Elderly/Disabled Credit*
  - *Research Activities Credit*
  - *Disabled Access Credit*
  - *Work Opportunity Credit*
  - *General Business Credit*
  - *Small Employer Health Insurance Credit*

Brief descriptions of each credit provided on page 6-22; please consult Whittenburg companion website to see which have been retroactively enabled for all of 2014

Individual Alternative Minimum Tax (AMT)

- Tax was originally intended for high income taxpayers with sheltered income, it has evolved to impact many middle income people
- Separate (parallel) system for calculating taxes
  - If AMT is higher than regular federal tax liability, must pay AMT amount
- AMT Rates*
  - 26% up to and equaling $182,500 ($91,250 MFS) AMT base
  - 28% above the amounts above
  - Long-term capital gains taxed at preferential rates

***See following slide for Alternative Minimum Tax model**

Alternative Minimum Tax

Calculation of Alternative Minimum Tax

Adjusted Gross Income

+/-	AMT Adjustments and Tax Preferences
=	Alternative Minimum Taxable Income
-	AMT Exemption
=	Amount Subject to AMT
x	AMT rate(s)
=	Tentative Minimum Tax
-	Regular Tax
=	AMT due with tax return (if positive amount)

Alternative Minimum Tax

- Adjustments are generally *timing differences*
- Preferences are generally special provisions for regular tax that are not allowed for the AMT
- Common adjustments and preferences include
  - State income tax refunds
  - Net operating loss calculated differently for AMT
  - Some passive gains/losses
  - Difference in regular depreciation and AMT depreciation
  - Exemptions
  - Most itemized deductions
  - Excess depletion over cost - intangible drilling costs
  - See complete list of preferences/adjustments (page 6-23)

AMT Exemptions

- AMT Exemption Amounts
  - $82,100 (MFJ)
  - $41,050 (MFS)
  - $52,800 (Single and Head of Household)
- Exemption is reduced by $.25 for each dollar of Alternative Minimum Taxable Income (AMTI) over phase-out amounts (see page 6-23)

Controversy with AMT

- Many middle class taxpayers now may be susceptible to AMT due to:
  - Disallowance of state income and property taxes deductions, personal/dependency exemptions, etc.
  - Reduction in regular tax rates not met by AMT tax rate reductions
  - AMT exemptions not indexed for inflation
- An opposing opinion is that AMT represents a gradual implementation of a “flat tax”

Unearned Income of Dependent Children

- Provision designed to prevent parents from transferring income-producing assets to children in lower tax brackets
  - Net unearned income (NUI) of dependent child is taxed at parent's highest tax rate
  - Applies to a child with at least one living parent, who is 18 or younger at end of tax year or students with ages 19-23, and has NUI

NUI =

Unearned income

Less the greater of $1,000 or itemized investment expenses

Less statutory deduction ($1,000)

“Kiddie Tax”

- If NUI is zero or less, child’s tax is calculated using the child’s tax rate
- If the amount is positive, child’s tax is calculated by applying the parent’s tax rate (but only if higher)
- Wages will always be taxed at the child’s lower tax rate
- Report on Form 8615

Election to Include Child’s NUI on Parent’s Tax Return

- Parents may elect to report the income of child under 18 on their tax return using Form 8814
  - Much simpler than filing return for child
  - Child’s NUI taxed at parent’s highest marginal tax rate
- Can elect if child is under 18 and
  - Has only interest/dividends and income is between $1,000 and $10,000
  - Paid no estimates or backup withholding during year

Community Property & Taxation

- Community property system assumes that all property is either separate or community
  - *Separate*: acquired before marriage (or acquired through gift or inheritance after marriage)
  - *Community*: acquired after marriage
- Special problem occurs when married couples file separate income tax returns - need to allocate income from jointly held property
- Nine states - AZ, CA, ID, LA, NV, NM, TX, WA, WI - follow the community property system
  - *This is different law from taxpayers residing in remaining 41 states*
- Each spouse is taxed on ½ of the income from community property

Same-Sex Couples

- In 2013, the U.S. Supreme Court struck down the portion of the Defense of Marriage Act which denied federal benefits to married same-sex couples
  - *Community property states that recognize same-sex marriage also accord community property rights to these unions*