Tax Tips You Can Use Aug 2008

THE BASIC'S – TAX FORM 1040 "CREDITS"

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In the continuing series of income tax basics, this topic is a more in depth look at a very interesting part of a tax return, the "credits" section.

A credit is a reduction of the actual tax that a taxpayer owes. You can find the credit section of your individual tax return on the second page of your 1040. Credits are an important part of the tax code, so this month's article will show how credits work, while September's article will discuss some interesting federal credits and October's article will look at Oregon credits.

A credit is different from a deduction. A deduction reduces a taxpayer's income and a credit reduces the actual tax. For example, if a taxpayer has $10,000 of taxable income and is in the 10% bracket, he will be liable for $1000 of tax. A $500 deduction will decrease his income to $9500 and his tax to $950. A $500 credit will reduce his tax to $500. Credits are <u>much</u> better than deductions.

Credits are another way for our government to influence taxpayer behavior. In simple terms, Congress wanted to improve fuel economy, so created a credit for buying a hybrid vehicle. This probably influenced some people to buy hybrids. Sadly, credits are also the way our government can create special favors- by creating credits that affect a limited number of individuals or businesses, sometimes one individual or business. The rest of us don't even know these credits exist.

Credits come in three flavors. There are nonrefundable credits, carryover credits and refundable credits.

A nonrefundable credit is vanilla because it is a one time, use it or lose it credit, for example, the education credit. If your tax liability is $800 and your education credit is $1000, your tax bill goes to zero and the extra $200 is lost.

A carryover credit allows you to carry to the next year that portion that you cannot use this year. There are few federal carryover credits, but the child care credit in Oregon can, sometimes, be carried over to the next year. So if your Oregon tax is $300 and your Oregon child care credit is $500, your Oregon tax goes to zero and up to $200 may be carried to your Oregon return next year. The rules are too complex for this short article, but taxpayers should be aware of items that carryover from year to year.

The "Rocky Road" of tax credits is the refundable credit. This type of credit is first used to reduce you tax liability. If the tax goes to zero and there is some leftover, that amount is changed to a "payment" and you get it in a refund or credit to lower your other taxes. The child tax credit was changed to refundable credit a few years ago. Some taxpayers with children have zero income tax due and a get a refund larger than what was paid in withholding.

Next month we will talk about the child tax credit and some other interesting federal credits.

The fine print is that this article is for information only. Please call Kathy or a tax professional for questions about your individual tax situation. The Jacksonville Tax Lady can be reached at 541-899-7926 or at 610 North Fifth Street.