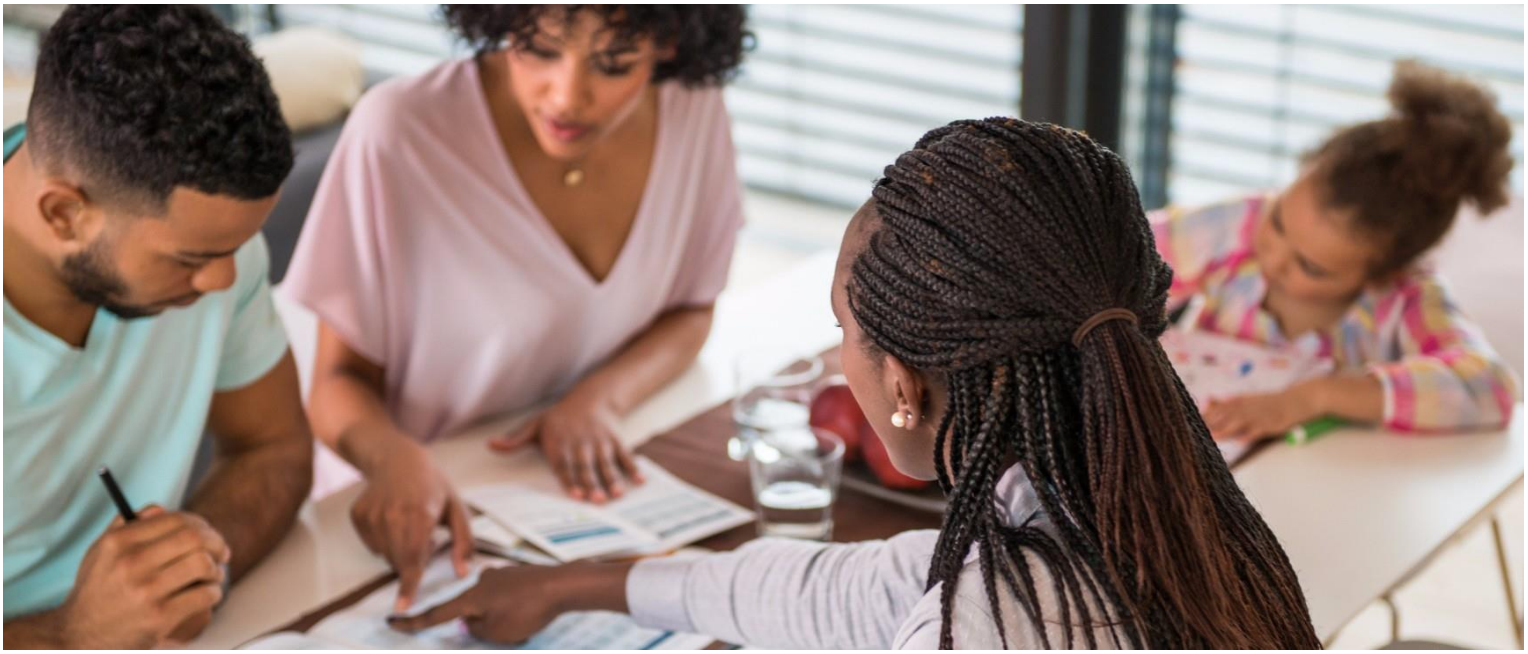
Understanding Personal Tax Credits



Have you ever thought that you're paying too much income tax? You may be, if you're not claiming all of the tax credits for which you are eligible when you file your federal tax return. These credits may significantly reduce your tax liability.

What is a tax credit?

A tax credit is a dollar-for-dollar reduction of your tax liability. Generally, after you've calculated your federal taxable income and worked out how much tax you owe, you can subtract the amount of any tax credit for which you are eligible from your tax obligation. In some cases, if your tax credits exceed your tax liability, you will be able to claim the difference as a refund.

What is the difference between a tax deduction and a tax credit?

A tax deduction reduces your taxable income, so that when you calculate your tax liability, you're doing so against a lower amount. Essentially, your tax obligation is reduced by the same percentage as your tax rate.

Here's an example. If you're in the 22 percent marginal tax bracket and you have $1,000 in tax deductions, your tax liability will be reduced by $220. That reduction would be greater if you were in a higher tax bracket.

A tax credit, on the other hand, is constant. A tax credit of $100 will reduce your tax liability by $100, regardless of your tax bracket. Here's a quick summary of some of the main personal federal tax credits that may be available to you.

Child and dependent care credit

If you're working or looking for work, and you need to pay someone to look after your child or other qualifying individual, you may be eligible for the child and dependent care credit. Depending on your adjusted gross income, you may be able to claim up to 35 percent of the qualifying expenses that you pay to provide care for a dependent child under the age of 13, a disabled spouse, or a disabled dependent. A dollar limit applies to the amount of work-related expenses you can use to figure the credit. This limit is $3,000 for one qualifying person, or $6,000 for two or more qualifying persons.

For more information, see IRS Publication 503.

Child tax credit

The child tax credit provides tax relief for parents and others who have dependent children. If you're eligible, you may be entitled to take a credit of up to $2,000 per child. A qualifying child is typically a child, grandchild, stepchild, or foster child under the age of 17 who lives with you for more than half the year and provides less than half of his or her own support.

The child tax credit begins to phase out if your modified adjusted gross income (MAGI) exceeds a certain level ($400,000 for married persons filing jointly, $200,000 in any other case).

For more information, see IRS Publication 972.

Earned income credit

The earned income credit benefits working taxpayers who have low income. You can apply for it only if you work, either as an employee or in your own business, and you have earned income during the tax year. The amount of the credit is based on your adjusted gross income, your filing status, and the number of qualifying children you have.

For more information, see IRS Publication 596.

Education credits

There are two tax credits that you may qualify for if you, your spouse, or your children are attending an eligible educational institution: the American Opportunity tax credit (formerly known as the Hope credit) and the Lifetime Learning credit. Whether you can claim one of these credits (they can't both be claimed in the same year for the same student) depends on your educational status, your modified adjusted gross income (MAGI), and the amount of qualified tuition and related expenses you pay in a given year.

The American Opportunity credit is worth a maximum of $2,500 per year and is available for each student in the household who is in the first four years of undergraduate education (provided the student is attending at least half-time). The Lifetime Learning credit is worth a maximum of $2,000 per year and is more widely available — students who are attending college or graduate school (even less than half-time), taking continuing education courses, or pursuing courses connected to hobbies and other interests may be eligible for this credit. However, the Lifetime Learning credit is limited to $2,000 per tax return per year, regardless of how many students in the family may qualify.

To qualify for the full Lifetime Learning credit, your MAGI must be below $59,000 in 2020 if you're a single filer and $118,000 in 2020 if you're a joint filer. Single filers with a MAGI between $59,000 and $69,000 and joint filers with a MAGI between $118,000 and $138,000 can claim a partial credit in 2020.

To qualify for the full American Opportunity credit, your MAGI must be below $80,000 if you're a single filer and $160,000 if you're a joint filer. Single filers with a MAGI between $80,000 and $90,000 and joint filers with a MAGI between $160,000 and $180,000 can claim a partial credit.

For more information, see IRS Publication 970.

Other tax credits

You may also be eligible for other federal tax credits, including the credits listed below:

- Adoption tax credit
- Tax credit for the elderly or the disabled
- Foreign tax credit
- Tax credit for IRA and retirement plan contributions (the retirement savings contribution, or "savers" credit)
- Health insurance premium assistance credit

If you would like more information on personal tax credits, contact your tax advisor or log on to the IRS website at www.irs.gov.

Tax Credit for IRAs and Retirement Plans (Saver's Credit)

What is it?

The Economic Growth and Tax Relief Reconciliation Act of 2001 made significant changes to IRAs and retirement plans. One provision of the act allows some low- and middle-income taxpayers to claim a partial, nonrefundable income tax credit (the "saver's credit") for contributing to certain tax-deferred retirement savings vehicles. The credit can be applied against the taxpayer's regular income tax liability (or minimum tax liability, if paying under the alternative minimum tax system) and is in addition to any income tax deduction the taxpayer receives for making the contribution. The purpose of this provision is to encourage retirement savings among those who, typically, can least afford to save.

What retirement savings vehicles are eligible for the tax credit?

The tax credit is available for elective contributions made to traditional IRAs, Roth IRAs, and the following employer-sponsored retirement plans: Section 401(k) plans, Section 403(b) annuities, Section 457(b) plans, SIMPLE plans, and SEP plans. Voluntary after-tax employee contributions made to a qualified retirement plan also qualify for the credit.

Who is eligible for the tax credit?

Not everyone who contributes to the retirement savings vehicles mentioned previously is eligible for the tax credit. To claim the credit, you must be at least 18 years old and not a full-time student or claimed as a dependent on another taxpayer's income tax return. In addition, there are income requirements that must be met. If you and your spouse file a joint income tax return, you can claim the credit for 2020 only if your combined adjusted gross income (AGI) for the year is $65,000 or less. If you file as head of household, you can claim the credit only if your AGI is $48,750 or less. Finally, if you file as an unmarried taxpayer or married filing separately, you can claim the credit only if your AGI is $32,500 or less.

How much is the tax credit?

The maximum annual contribution eligible for the tax credit is $2,000, and the maximum credit rate is 50 percent of the amount contributed. This means that the maximum possible credit that a taxpayer could receive in one year is $1,000. However, not everyone who qualifies for the credit will be able to claim the full credit. The specific amount of your credit (if any) in any year will depend on three factors: your AGI for the year, your income tax filing status for the year, and the amount of your IRA or retirement plan contribution for the year. The following tables (for 2019 and 2020, respectively) provide the credit rates based on AGI and filing status:

2019

Joint Filers	Heads of Household	Single Filers	Credit Rate
$0-$38,500	$0-$28,875	$0-$19,250	50% of contribution (up to $2,000)
$38,501-$41,500	$28,876-$31,125	$19,251-$20,750	20%
$41,501-$64,000	$31,126-$48,000	$20,751-$32,000	10%
Over $64,000	Over $48,000	Over $32,000	0%

2020

Joint Filers	Heads of Household	Single Filers	Credit Rate
$0-$39,000	$0-$29,250	$0-$19,500	50% of contribution (up to $2,000)
$39,001-$42,500	$29,251-$31,875	$19,501-$21,250	20%
$42,501-$65,000	$31,876-$48,750	$21,251-$32,500	10%
Over $65,000	Over $48,750	Over $32,500	0%

Finally, be aware that the amount of any contribution eligible for the credit may be reduced by any taxable distributions that you and your spouse receive from any of the retirement savings vehicles mentioned previously (or from any other qualified retirement plan). This reduction applies to distributions received during the same tax year that the credit is claimed, the two tax years prior to the tax year that the credit is claimed, and during the period after the end of the tax year and prior to the due date for filing your tax return for the year. In the case of a Roth IRA, this rule applies to any distributions received, whether taxable or nontaxable.

Beneficiary Designations

What is it?

In general

A beneficiary designation is one form of will substitute. It allows you to transfer certain assets, such as the proceeds of a life insurance policy or a retirement plan (e.g., an IRA, 401(k), or 403(b)), without going through probate. The person or entity you choose to receive the proceeds is called a beneficiary. If you're single, you can choose anyone you wish as the beneficiary. If you're married, the law may restrict your choice. You can also name a charitable institution, your estate, or a trust as the beneficiary of many retirement plans.

Retirement plans

- Spouse as beneficiary: Some retirement plans require you to name your spouse as the beneficiary, unless he or she signs a written waiver consenting to your choice of another beneficiary.

Tip: *If your spouse agrees to a waiver, he or she may need to sign a form provided by the plan, with the plan's representative or a notary acting as witness. A spouse who consents to a particular beneficiary may withdraw that consent if you later name a different beneficiary.*

Caution: *A prenuptial agreement cannot take the place of a waiver because the law requires your spouse--not your intended spouse--to sign.*

- Child as beneficiary: It's common to name a minor (a child under the age of 18) as the beneficiary of a retirement account. You could name your children (if you're a single parent), your grandchildren, or a young friend or relative. Even if you don't name a child as your primary beneficiary, you may want to name one as an alternate.

Tip: *If you name a child as a beneficiary, you should also appoint an adult to act as guardian of the money. Otherwise, if you die while the child is still a minor, the child's parents may have to petition the court to act as guardians. If the child's parents are no longer alive, the child's court-appointed guardian will handle the money. The court's involvement can be costly, time-consuming, and intrusive. It's best to avoid it if possible. The easiest way to name someone as a guardian of a child's property is to appoint an adult as a "custodian" of the money. Custodians are authorized under the Uniform Transfers to Minors Act (UTMA), which most states have adopted.*

- Another adult as beneficiary: As long as your spouse consents you can name anyone you wish as your beneficiary. If you name more than one person, your beneficiaries will receive equal shares unless you specify otherwise.
- Charity as beneficiary: You can name a charitable institution (such as a church, hospital, college, or university) as the beneficiary of your retirement account.
- Trust as beneficiary: In some circumstances it's best not to name a trust as the beneficiary. You don't need to name a living trust as a beneficiary to avoid probate. As long as you name a beneficiary (other than your estate), the money won't go through probate anyway.
- Estate as beneficiary: You should avoid naming your estate as beneficiary. If you do, the money will go through probate before being distributed. Furthermore, the income tax consequences of naming your estate as beneficiary are often quite undesirable.

Caution: *Many IRAs and qualified retirement plans include provisions to prevent an unintended person from being treated as the beneficiary and to eliminate lawsuits that often arise when there are competing beneficiaries. These provisions require at least one year of marriage to receive spousal benefits, call for the automatic termination upon divorce of a spouse as beneficiary, and eliminate the need for beneficiary changes to be filed on an "official" form. If your IRA or plan doesn't contain these provisions and you want to use them, ask your practitioner to add them to the list of items on the customized beneficiary designation.*

Life insurance

You can name anyone you wish (with the one exception noted below) as the beneficiary of your life insurance policy. Many people choose a family member, such as a surviving spouse or child, but you're not required to do that. You can also name a charitable institution or a trust.

Caution: *You may not name your employer as the beneficiary of group life insurance coverage that he or she provides.*

When can it be used?

If you own life insurance or participate in a retirement plan

You can use a beneficiary designation if you own a life insurance policy or if you participate in a retirement plan such as an IRA, 401(k) plan, or 403(b) plan. You could also transfer assets under a beneficiary designation on transfer on death or payable on death registrations for certain assets.

If you want to avoid probate

Probate can be a lengthy and costly process. Assets that pass through probate may take a year or more to reach your beneficiaries, and you run the risk that they may not reach the people you intended. Also, probate records are open to the public, so knowledge of how you've bequeathed your estate is available to anyone who inquires.

Strengths

Easy to set up; costs nothing

It's easy to designate a beneficiary and it costs nothing. You simply file the appropriate form with your plan administrator or your life insurance company.

Avoids probate

The proceeds of a life insurance policy or a retirement account avoid probate, passing automatically to your beneficiary at your death (assuming you did not name your estate or executor as beneficiary).

You own the property until your death

Your retirement plan and your life insurance policy remain in your name until you die, although others invest and control the funds. Because the assets remain in your name, you may be able to borrow against the funds in a retirement account. Or, you could cash in your life insurance policy to provide needed income if you were faced with a terminal illness or other emergency. In other words, by using a beneficiary designation as an estate planning tool, you haven't made an irrevocable choice, as you would have if you'd set up an irrevocable trust . (In most forms of property ownership, including some joint tenancies, the transferor would retain access to the transferred funds and could easily undo the transfer.)

However, owning a life insurance policy has estate tax consequences. For more information, see tradeoffs.

You can change the beneficiary at any time, subject to certain rights of your spouse

You can change your beneficiary at any time. However, if you're married, your spouse may have to consent to a change in the beneficiary of certain retirement accounts.

Life insurance proceeds are not subject to income tax

Death proceeds received under a life insurance policy generally aren't subject to income tax. However, if a beneficiary receives the death proceeds under a settlement option, interest earned on the proceeds is subject to income tax.

If you sell or transfer life insurance for consideration (in other words, on any basis other than as a gift), be aware of the transfer-for-value rule.

Tradeoffs

Retirement plan proceeds are subject to income tax

Retirement plan proceeds are subject to income tax when the money is paid or withdrawals are made.

Proceeds may be subject to estate tax

Normally, your entire interest in a retirement plan or life insurance policy at the time of your death is added to your other assets in determining whether any estate tax is owed. When you designate your spouse as the beneficiary, however, no estate tax is owed due to the unlimited marital deduction.

Choice of beneficiary is a key factor in determining how quickly the funds must be distributed after you die

Your choice of beneficiary is a factor in determining how quickly retirement plan funds must be distributed after you die. Surviving spouses have more options for handling the money than do other beneficiaries. A surviving spouse can keep the money tax-deferred at least for a while, either by rolling it over into his or her IRA or by leaving it as is.

Your retirement plan may not allow you to name an alternate beneficiary

Some plans don't allow for the naming of an alternate beneficiary. You must check with your plan regarding its specific rules.

You lose control of the funds after your death, unless you use a trust

Once you're gone, your beneficiary is free to use the funds as he or she pleases, unless you use a trust. A spouse may remarry, or simply change his or her mind about providing for the children from your first marriage.

Tip: *If this is a concern, consider naming a trust as the beneficiary.*

How to do it

Retirement plans

Usually, written notification is sufficient to name or change a beneficiary, but some plans use their own forms. Your plan’s website may also allow you to select beneficiaries.

Caution: *You must comply with the provisions of your retirement plan. You cannot simply designate or change a beneficiary of a retirement plan in your will.*

Life insurance

Fill out a beneficiary designation form with your insurance company. You can change the beneficiary at any time, unless you have made your choice irrevocable, simply by filing a new beneficiary designation form.

Caution: *You must comply with your insurer's requirements. You cannot simply designate or change a beneficiary in your will.*

Tax considerations

Income Tax

Retirement plans

Your retirement account savings are exempt from income tax during your life, but after your death, your beneficiary is taxed on the proceeds. Income tax isn't owed until withdrawals are made. Your choice of beneficiary has an impact on the tax consequences. For example, if your surviving spouse rolls the money over, he or she does not have to pay income tax until withdrawals start. If the account is left as is, your surviving spouse does not have to pay the 10 percent early withdrawal penalty, even if he or she is under the age of 59½.

Life insurance

Beneficiaries generally don't pay income tax on death benefits paid under a life insurance policy. However, if you or a beneficiary receive the death benefit under a settlement option, interest earned on the proceeds is subject to income tax (although the proceeds themselves aren't taxed).

Gift and Estate Tax

Estate tax

Proceeds of a retirement plan or life insurance policy are usually subject to estate tax at your death. However, when you designate your spouse as the beneficiary, estate tax generally will not be imposed due to the unlimited marital deduction.

Questions & Answers

Can you name more than one person as your beneficiary?

You generally can name more than one person as your beneficiary, subject to certain spousal rights for some retirement plans. If you name more than one person, your beneficiaries will receive equal shares unless you specify otherwise.

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