**Chapter Six**

**Credits and Special Taxes**

**Learning Objective 6.1 Child Tax Credit**

If taxpayers have children under age 17, U.S. citizens and claimed as dependents on the taxpayer’s return, a credit is offered based on the number of children.

The maximum credit is $1,000 per child, but there is a phase out once AGI reaches $110,000 for married filing joint (MFJ), $55,000 for married filing separately (MFS) and $75,000 for single or head of household (HOH) taxpayers.

**Learning Objective 6.2 Earned Income Credit**

The Earned Income Credit (EIC) is for qualifying individuals with income below certain levels. The EIC is unique because this particular credit can result in a refund to the taxpayer. The EIC is determined based on the AGI of the taxpayer and the number of qualifying children. Again, the children must meet a relationship test (child, stepchild, foster child or adopted child), residency test (U.S., at least six months, except for foster children which is for the full year), and an age test (typically under 19, except for full-time college students under 24, or a permanently and totally disabled child regardless of age).

**Learning Objective 6.3 Child and Dependent Care Credit**

Taxpayers are allowed a credit for the care of their children and certain other dependents. To be eligible for a child care credit or dependent care credit, the taxpayer must maintain a household for a child whose age is 13 or under or a dependent or spouse of any age who is incapable of self-care. The allowable credit is based on AGI and qualified expenses. Qualified expenses include amounts paid to enable both the taxpayer and spouse to be employed. The taxpayer must include the name, address, and taxpayer identification number of the person or organization providing care on their return to claim the credit. The allowable credit is equal to 35% of the qualifying expense if AGI is $15,000 or less. The maximum credit allowed is $3,000 for one dependent and $6,000 for two or more dependents.

**Learning Objective 6.4 The Affordable Care Act**

The ACA was passed in 2010 with significant provisions being implemented overtime. In 2013 the Net Investment income tax of 3.8 percent and the Medicare Surtax of 0.9 percent on earned income started affecting high-income taxpayers. In late 2013, purchasing health care through the state or federal exchanges took effect. Two important tax-related provisions affecting taxpayers begin in 2014; 1) the Individual Shared Responsibility Provision and 2) Health Insurance Premium Tax Credits.

Individual Shared Responsibility

The individual shared responsibility provision is a “penalty tax” for failing to carry health insurance at a minimum level. This provision requires a taxpayer and members of the taxpayer’s family to have a minimum essential coverage level (MEC) or an exemption from the MEC. Failure to carry the MEC causes the taxpayer to pay an additional tax when filing their annual federal tax return. In 2014, the individual shared responsibility is the lesser of: 1) 1 percent of household income above the required filing threshold or 2) the 2014 flat annual dollar amount of $95 per adult and $47.50 per child limited to a family maximum of $285. Both of these are subject to a cap. Household income is defined as total adjusted gross income of all household members for which a personal exemption is claimed plus tax-exempt income (not including exempt Social Security benefits).

Premium Tax Credit

Eligible taxpayers may receive a tax credit intended to lower the cost of health care. To be eligible taxpayers must meet all of the following:

* Health insurance is purchased through one of the state exchanges or the federal exchange
* The taxpayer is not eligible for coverage through an employer or government plan
* The taxpayer’s income falls below certain levels
* The taxpayer does not file Married Filing Separately except under very limited conditions
* The taxpayer cannot be claimed as a dependent by another.

The credit is calculated using specific tax tables similar to those used to calculate the Earned Income Credit. If qualified, the credit can be obtained at two different times: 1) upfront (i.e., at time of enrollment) or 2) at the end of the year when the annual federal tax return is filed. Income eligibility is based on total adjusted gross income of all household members for which a personal exemption is claimed plus tax-exempt interest and any nontaxable social security.

**Learning Objective 6.5 Education Tax Credits**

Taxpayers who are paying for higher education have two credits, the American Opportunity credit and the lifetime learning credit. These credits are for tuition but not for room and board. The American Opportunity credit is 100 percent of the first $2,000 of tuition, fees, books and course materials paid and 25% of the next $2,000 (maximum credit of $2,500) per student. This credit is available for the first four years of post-secondary education. The phase-out for the educational credits is between $160,000 and $180,000 for joint filers and $80,000 and $90,000 for other. The American Opportunity credit is 40% refundable, therefore it can reduce the taxpayer’s liability to below zero. To qualify, a student must be taking one-half the normal course load and cannot be convicted of a federal or state drug felony.

The lifetime learning credit is a nonrefundable credit of 20% of tuition and fees up to $10,000 (maximum credit of $2,000) per year. The phase-out for the educational credits is between $108,000 and $128,000 for joint filers and $54,000 and $64,000 for others. Students cannot claim both credits in the same year, but if more than one student is eligible for the credits, both types can be claimed.

**Learning Objective 6.6 Foreign Tax Credit**

U.S. taxpayers are allowed a credit for the taxes paid to other countries. The purpose is to eliminate double taxation. Unused foreign tax credits can be carried back two years or carried forward five years.

**Learning Objective 6.7 Adoption Expenses**

Individuals are allowed an income tax credit for qualified adoption expense. There is only one $13,190 credit per adopted child. A phase-out begins when the taxpayer’s AGI is over $197,880. Qualified adoption expenses are the reasonable and necessary adoption fees, court costs, attorney fees and other expenses directly related to and the principal purpose of which is for the taxpayer’s legal adoption of an eligible child.

**Learning Objective 6.8 Energy Credits**

To encourage the use of energy-efficient products, there are two major energy credits available in 2014. The plug-in electric vehicle credit applies to the purchase of plug-in electric vehicles and the credits range between $2,500 and $7,500 depending on the weight of the vehicle and the kilowatt hour of traction battery capacity. The Residential Energy-Efficient Property (REEP) credit is expected to increase the number of solar and wind energy installations in the coming years. For tax year 2014, taxpayers may claim a credit of 30 percent of the amount paid for qualified solar electric property (property which uses solar power to generate electricity in a home), or qualified solar water-heating property, qualified small wind energy property and qualified geothermal heat pump property. These credits may not be used for installations used to heat swimming pools or hot tubs, but may be claimed for both principal residences and vacation homes.

**Learning Objective 6.9 The Individual Alternative Minimum Tax (AMT)**

The Internal Revenue Service has created a minimum tax to insure that every taxpayer with economic income pays at least some amount of income tax. The 2014 AMT rates are 26 percent on the first $182,500 ($91,250 – MFS) plus 28 percent on the amounts above $182,500. A taxpayer’s AMT is based on taxable income plus or minus certain adjustments, adding the amount of “tax preferences” and subtracting an exemption allowance based on tax filing status.

**Learning Objective 6.10 Unearned Income of Minor Children and Certain Students**

Many taxpayers put income-earning assets in the names of their children in order to pay a lower tax rate. However, the Tax Reform Act of 1986 limits the benefit of shifting income to minor children. Children who are younger than eighteen years old must pay a “parental rate”. Parents may also elect to include a child’s gross income on the parent’s tax return, therefore eliminating the need to file a return for the child. To make this election, the child’s gross income must be from interest and dividends only, the gross income is more than $1,000 but less than $10,000 and no estimated tax has been paid in the name of the child.

**Learning Objective 6.11 Community Property**

Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington and Wisconsin are community property states. In Alaska spouses may elect to treat income as community income. Property owned before the marriage or property received as an inheritance is separate property. All other property is assumed to be community property and federal income tax must be allocated to each spouse. In all of the community property states, income from salary and wages is generally treated as having been earned one-half by each spouse.

A special provision is allowed when married spouses residing in a community property state do not live together. A spouse will be taxed only on his or her actual earnings from personal services when; 1) the live apart the entire year, 2) they do not file a joint return, and 3) no portion of earned income is transferred between spouses.

Same-sex couples’ legally married under state law will now be required to file as married for federal tax purposes. Community property states that recognize same-sex marriages also extend community property rights. In addition, the rules when filing separately equally apply.