



(4)

Tax Credits

*Edwin Renán Maldonado ©
Catedrático - Universidad de Puerto Rico
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Textbook: Taxation of Individuals and Business Entities, Spilker



- This presentation contains information, in addition to the material prepared and provided by the professor, from the book Taxation of Individuals and Business Entities, 2017 Ed., Spilker which is the textbook assigned for the course CONT 4076 – “Aspectos Contributivos de Individuos” at the University of Puerto Rico, Río Piedras Campus.



Learning Objectives

1. Describe the different general types of tax credits, general identify specific tax credits.
2. Compute a taxpayer's allowable specific tax credits.

Tax Credits





Tax Credits

1.1 Definition



Tax Credits

1.1 Definition

- A tax credit reduce tax liability dollar for dollar.



Tax Credits

Example 1



Tax Credits

Example 1

- Taxpayer's income tax liability is \$1,000. Taxpayer's credits available amounts \$800.

● Income Tax Liability	\$1,000
● Less: Credits	<u>800</u>
● Income tax due	<u>\$ 200</u>



Tax Credit

1.2 Types of Tax Credits



Tax Credit

1.2 Types of Tax Credits

- General types of tax credits consist of three categories:
 1. Refundable personal credits
 2. Nonrefundable personal credits
 3. Business credits



Tax Credits

1.2 Types of Tax Credits

1. **Refundable Personal Credits:**

Refundable credits in excess of a taxpayer's gross tax liability are refunded to the taxpayer.

- Ex. Income tax withheld.



Tax Credits

Example 2

- Taxpayer's income tax liability is \$1,000. The Taxpayer's employer withheld income tax of \$1,100.

● Income Tax Liability	\$1,000
● Less: Credits	<u>1,100</u>
● Income tax refund	<u>\$ 100</u>

- The \$100 credit in excess of the income tax liability is refunded to the taxpayer.



Tax Credits

1.2 Types of Tax Credits

- 2. Nonrefundable Personal Credits:** A nonrefundable personal credit may reduce a taxpayer's gross tax liability to zero, but if the amount of the credit exceeds the amount of the taxpayer's gross tax liability, the credit in excess of the gross tax liability is not refunded to the taxpayer and expires without ever providing tax benefits (unless the unused credit can be carried over to a different year).



Tax Credits

Example 3

- Taxpayer's income tax liability is \$1,000. Taxpayer's nonrefundable credits available amounts \$1,100.

● Income Tax Liability	\$1,000
● Less: Credits	<u>1,100</u>
● Income tax due	<u>\$ 0</u>

- The \$100 credit in excess of the income tax liability is not refunded.



Tax Credits

1.2 Types of Tax Credits

3. **Business Credits:** The business credits are designed to provide incentives for taxpayers to hire certain types of individuals or to participate in certain business activities.
 - *Example:* Employment tax credit: To encourage businesses to hire certain unemployed individuals.

Nonrefundable Personal Tax Credits



Nonrefundable Personal Tax Credits



2.1 Types of Nonrefundable Personal Tax Credits

Nonrefundable Personal Tax Credits



2.1 Types of Nonrefundable Personal Tax Credits

1. Child Tax Credit (partially refundable)
2. Child and Dependent Care Credit
3. Education Credits
 1. American Opportunity Credit
 2. Lifetime Learning Credit

Nonrefundable Personal Tax Credits



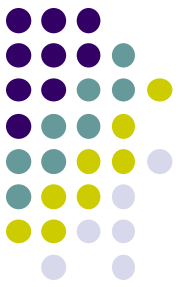
2.2 Child Tax Credit

Nonrefundable Personal Tax Credits



2.2 Child Tax Credit

- The child tax credit provides tax relief for taxpayers who provide a home for dependent children.
- \$1,000 for each qualifying child under age 17 at end of year.
 - Partially refundable in certain situations.



Nonrefundable Personal Tax Credits

2.2 Child Tax Credit

- The \$1,000 is subject to phase-out based on the taxpayer's AGI.
- Phase-out
 - Married filing jointly \$110,000
 - Married filing separately \$ 55,000
 - Head of Household and single \$ 75,000
- If the taxpayer's AGI exceed the threshold amount, the credit of \$1,000 is phase-out by \$50 for each \$1,000 or portion thereof by which the taxpayer's AGI exceeds the applicable threshold.

Nonrefundable Personal Tax Credits



Example 4



Nonrefundable Personal Tax Credits

Example 4

- A head of household taxpayer's qualifying children follows:
 - Ellen, 10 years old.
 - Deron, 19 years old.
- Taxpayer's AGI is **\$62,000**.

What amount of child tax credit is taxpayer allowed to claim?

Nonrefundable Personal Tax Credits



Example 4

- Only Ellen qualifies for the child tax credit. Deron does not qualified because he is over age 17.
- Taxpayer's AGI of \$62,000 < \$75,000 threshold for a head of household. No phase-out is required.
- Consequently, the taxpayer can claim a child tax credit of \$1,000 for Ellen.

Nonrefundable Personal Tax Credits



Example 5

Nonrefundable Personal Tax Credits



Example 5

- A head of household taxpayer's qualifying children follows:
 - Ellen, 10 years old.
 - Deron, 19 years old.

Taxpayer's AGI is **\$162,000**.

What amount of child tax credit is taxpayer allowed to claim?



Nonrefundable Personal Tax Credits

Example 5

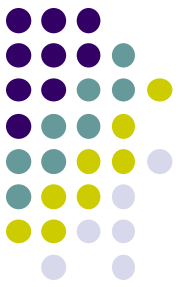
- Taxpayer's AGI of \$162,000 > \$75,000 threshold for a head of household. Therefore, the taxpayer's must determine his/her credit after the phase-out is computed.

• AGI	\$162,000
• Less: threshold	<u>75,000</u>
• Excess	87,000
• Divided \$1,000	<u>1,000</u>
• DFDF	87
• Multiply by \$50	<u>50</u>
• Amount of the phase out	<u>4,350</u>
• Tax Credit Allowed	\$ <u>0</u> (\$1,000-\$4,350)

Nonrefundable Personal Tax Credits



2.3 Child and Dependent Care Credit



Nonrefundable Personal Tax Credits

2.3 Child and Dependent Care Credit

- This credit provides tax relief for taxpayers who incur expenses to care for their children and other dependents in order to work or look for work.



Nonrefundable Personal Tax Credits

2.3 Child and Dependent Care Credit

- A qualifying person includes:
 1. Dependent under age of 13, or
 2. disabled dependent or spouse (who live with taxpayer for more than half the year).
- The caregiver cannot be a dependent or child of the taxpayer.



Nonrefundable Personal Tax Credits

2.3 Child and Dependent Care Credit

- The amount of expenditure eligible for the credit is the least of the following three amounts:
 1. The amount of dependent care expenditures for the year.
 2. Maximum qualifying expenditures:
 - \$3,000 one qualifying person,
 - \$6,000 two or more qualifying persons.
 3. The taxpayer's earned income (wage, salary, net earnings from self employment). Married filing jointly, the earned income of the lesser-earning spouse.



Nonrefundable Personal Tax Credits

2.3 Child and Dependent Care Credit

- **CREDIT =**

EXPENDITURE
ELIGIBLE

X

PERCENTAGE ON AGI
AS PRESENTED IN
TABLE ON NEXT PAGE



Nonrefundable Personal Tax Credit

EXHIBIT 8-9 Child and Dependent Care Credit Percentage

If AGI is over	but not over	then the percentage is
\$ 0	15,000	35%
15,000	17,000	34
17,000	19,000	33
19,000	21,000	32
21,000	23,000	31
23,000	25,000	30
25,000	27,000	29
27,000	29,000	28
29,000	31,000	27
31,000	33,000	26
33,000	35,000	25
35,000	37,000	24
37,000	39,000	23
39,000	41,000	22
41,000	43,000	21
43,000	No limit	20

Nonrefundable Personal Tax Credits



Example 6



Nonrefundable Personal Tax Credits

Example 6

- A head of household taxpayer's qualifying children follows:
 - Ellen, 10 years old.
 - Deron, 19 years old.
- Taxpayer's AGI is \$162,000 (salary \$140,800 + net rent income \$21,200)
- Taxpayer paid a neighbor \$3,200 to care for Ellen so taxpayer could work.

What amount of child and dependent care tax credit is taxpayer allowed to claim?



Nonrefundable Personal Tax Credits

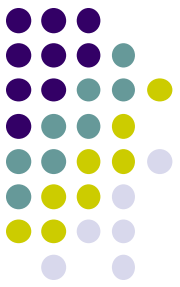
Example 6

- Ellen qualify because she is under 13 years old and her caretaker is not dependent of the taxpayer. Taxpayer's AGI is \$162,000.
- The expenditure eligible is \$3,000, the least of:
 1. Care expenditure: \$3,200.
 2. Maximum qualifying expenditure: \$3,000.
 3. Earned income: \$140,800.
- The percentage allowable is 20%, since earned income \$162,000 > \$43,000.
- **Credit is \$600 (\$3,000 x 20%)**

Nonrefundable Personal Tax Credits



2.4 American Opportunity Credit [Education Credit]



Nonrefundable Personal Tax Credits

2.4 American Opportunity Credit [Education Credit]

- This is an education credit where taxpayers may claim credit for eligible expenditures made for:
 1. themselves,
 2. their dependents, and
 3. third parties on behalf of the taxpayers' dependents. (*the expenses were paid by a third party*)

Nonrefundable Personal Tax Credits



2.4 American Opportunity Credit [Education Credit]

● Requirements:

1. Credit available for taxpayer, spouse and dependents.
2. For educational eligible expenses incurred in the ***first four years*** of post-secondary education at least half time. Eligible expenses are tuition and course materials. Room and board is not eligible.
3. The American Opportunity Credit (AOC) is applied on a **per student basis**. Taxpayer can claim a maximum of AOC of \$2,500 per each eligible dependent.

Nonrefundable Personal Tax Credits



2.4 American Opportunity Credit [Education Credit]

- **Requirements:**

4. Amounts paid by dependents themselves (or paid by another taxpayer) treated as paid by taxpayer.
5. To be eligible for the 2017 credit, taxpayers must pay the eligible expenses in 2017 for any academic period beginning in 2017 or in the first three months of 2018.
6. Married filing separate returns are not eligible for the AOC or the lifetime learning credit.

Nonrefundable Personal Tax Credits



2.4 American Opportunity Credit [Education Credit]

● **Computation:**

- 100% of first \$2,000 of eligible expenses and 25% of next \$2,000 (maximum credit is \$2,500 for each dependent).
- Phase-out based pro rata on AGI between \$80,000 and \$90,000 (\$160,000 - \$180,000 married filing jointly).
- 40% of credit is refundable. [*Not applicable to a taxpayer that is a child subject to the “kiddie tax” rules.*]

American Opportunity Credit



Example 7:

American Opportunity Credit



Example 7:

- Taxpayer paid \$2,000 of tuition and \$300 for books for Deron to attend the University of Missouri–Kansas City during the summer at the end of her freshman year.

What is the maximum American opportunity credit (before phase-out) Taxpayer may claim for these expenses?



American Opportunity Credit

Example 7:

- Tuition and books are eligible expenses, then:

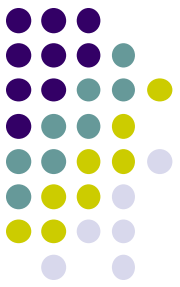
First \$2,000 allowed:	\$2,000
25% of next \$300	<u>75</u>
Maximum AOC	<u>\$2,075</u>

- The **credit is \$2,075** and the portion **refundable is \$830** ($\$2,075 \times 40\%$)



American Opportunity Credit

Example 8: (Refer to example 7)



American Opportunity Credit

Example 8: (Refer to example 7)

- Assuming Taxpayer qualifies for a \$2,075 American Opportunity Credit, she is married filing jointly, and her AGI is \$162,000.

What amount of American Opportunity Credit would she be allowed to claim after phase-out?



American Opportunity Credit

Answer: \$1,867, computed as follows:

Description	Amount	Explanation
(1) AOC before phase-out	\$ 2,075	
(2) AGI	182,000	
(3) Phase-out threshold	160,000	
(4) Excess AGI	2,000	(2) – (3)
(5) Phase-out range for taxpayer filing for married filing jointly	20,000	\$180,000 – 160,000
(6) Phase-out percentage	10%	(4)/(5)
(7) Phase-out amount	208	(1) × (6)
AOC after phase-out	\$ 1,867	(1) – (7)



American Opportunity Credit

Example 8: (Refer to example 7)

- **What amount of American Opportunity Credit would she be allowed to claim after phase-out?**
- The credit is \$1,867 (as presented on previous page).
- The amount refundable is \$747 ($\$1,867 \times 40\%$)

Nonrefundable Personal Tax Credits



2.5 Lifetime Learning Credit [Education Credit]

Nonrefundable Personal Tax Credits



2.5 Lifetime Learning Credit [Education Credit]

- **Requirements:**

1. Credit available for taxpayer, spouse and dependents, BUT, limited to only **one** student.
 - a. Applied *per* taxpayer. MFJ return is one taxpayer.
2. Eligible expenses (tuition, not book) for post-secondary education to acquire or improve a **taxpayer's** job skills.
 - a. Includes professional or graduate school.
 - b. Includes continuing education.
 - c. Can include the first four year of post secondary education.

Nonrefundable Personal Tax Credits



2.5 Lifetime Learning Credit [Education Credit]

- **Requirements:**

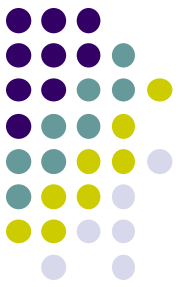
3. For expenses that qualify for both the American Opportunity Credit (AOP) and lifetime learning credit, taxpayer may choose which credit to use, BUT they may **not** claim both credits for the same students in the same year.

Nonrefundable Personal Tax Credits



2.5 Lifetime Learning Credit [Education Credit]

- **Computation:**
 - 20% of eligible expenses up to \$10,000 of eligible expenses. (maximum credit \$2,000)
 - For **2017**, phase-out pro rata based on AGI \$56,000 and \$66,000 (\$112,000 and \$132,000 married filing jointly).



Nonrefundable Personal Tax Credits

2.5 Lifetime Learning Credit [Education Credit]

- **Education Credits:** If deduct *for* AGI educational expenses for someone, **no** education credit allowed for that person.
 - **Example:** The taxpayer could take American Opportunity Credit for one dependent and for AGI deduction for another.

Refundable Personal Tax Credits



Refundable Personal Tax Credits



3.1 Earned Income Credit

Refundable Personal Tax Credits



3.1 Earned Income Credit

- The earned income credit is a refundable credit that is designed:
 1. to help offset the effect of employment taxes on compensation paid to low-income taxpayers **and**
 2. to encourage lower-income taxpayers to seek employment.
- Negative Income Tax: If the credit exceeds the tax, taxpayer **receives a refund** for the excess.



Refundable Personal Tax Credits

3.1 Earned Income Credit

- Requirements for **2017**:
 1. Must have earned income.
 - Taxpayers with investment income of interest, dividends and capital gains in excess of \$3,450 are ineligible for the credit.
 2. Must have at least **one** qualifying child **or** must be at least 25 years old and younger than 65 and not a dependent of another.
- See table on next page.

Refundable Personal Tax Credits



EXHIBIT 8-10 2017 Earned Income Credit Table

Qualifying Children	(1) Maximum Earned Income Eligible for Credit	(2) Credit %	(3) Maximum Credit (1) × (2)	(4) Credit Phase-Out for AGI (or earned income if greater) Over This Amount	(5) Phase-Out Percentage	No Credit When AGI (or earned income if greater) Equals or Exceeds This Amount (4) + [(3)/(5)]
Married taxpayers filing joint returns						
0	\$ 6,670	7.65%	\$ 510	\$13,930	7.65%	\$20,600
1	10,000	34	3,400	23,930	15.98	45,207
2	14,040	40	5,616	23,930	21.06	50,597
3+	14,040	45	6,318	23,930	21.06	53,930
All taxpayers <i>except</i> married taxpayers filing joint returns						
0	\$ 6,670	7.65%	\$ 510	\$ 8,340	7.65%	\$15,010
1	10,000	34	3,400	18,340	15.98	39,617
2	14,040	40	5,616	18,340	21.06	45,007
3+	14,040	45	6,318	18,340	21.06	48,340

Refundable Personal Tax Credits



Example 9

Refundable Personal Tax Credits



Example 9

- A head of household taxpayer's earned income for the year is \$140,800 [**Example 6**] and her Adjusted Gross Income (AGI) is \$162,000.
- Deron and Ellen both qualify as taxpayer's qualifying children.

What amount of earned income credit is taxpayer entitled to claim on her 2017 tax return?

Refundable Personal Tax Credits



Example 9

- What amount of earned income credit is taxpayer entitled to claim on her 2017 tax return?
 - **\$0.** Taxpayer's AGI (which is greater than her earned income) exceeds the \$45,007 limit for unmarried taxpayers with two or more qualifying children.
 - Consequently, taxpayer is not allowed to claim any earned income credit.

Refundable Personal Tax Credits



Example 10

Refundable Personal Tax Credits

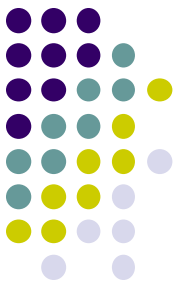


Example 10

- Refer to **Example 9**. Assume that taxpayer's only source of income for the year is \$30,000 in salary and, then, her Adjusted Gross Income (AGI) is \$30,000.

What amount of earned income credit is taxpayer entitled to claim on her 2017 tax return?

Refundable Personal Tax Credits



Example 10

- What amount of earned income credit is taxpayer entitled to claim on her 2017 tax return?

Description	Amount	Credit
Maximum Earned Income Eligible for Credit for a head of household with 2 dependent.	\$14,040	
X Credit %	40%	
Maximum Credit		\$5,616
Phase-out of the greater of (a) AGI, or (b) earned income, over \$18,340 [\$30,000 - \$18,340]	\$11,660	
X Phase-out %	21.06%	
Credit phase-out amount		2,456
EARNED INCOME CREDIT		\$3,160

Business Tax Credits





Business Tax Credits

4.1 Rationale of Business Credits

Business Tax Credits



4.1 Rationale of Business Credits

- Business tax credits are designed to provide incentives for taxpayers to hire certain types of individuals or to participate in certain business activities. For **example**,
 1. Congress provides the employment tax credit to encourage businesses to hire certain unemployed individuals, and
 2. it provides the research and development credit to encourage businesses to expend funds to develop new technology.



Business Tax Credits

4.1 Rationale of Business Credits

- Refer to **Exhibit 8-11**, on page 8-34, for a summary of selected business tax credits, among others.



Business Tax Credits

4.2 Characteristics of Business Credits

Business Tax Credits



4.2 Characteristics of Business Credits

1. **Self-Employed Individuals and Flow-through entities Income:**

- Self-employed individuals may qualify for business credits.
- Individuals may be allocated business credits from flow-through entities (partnership, LLCs, and S corporations).



Business Tax Credits

4.2 Characteristics of Business Credits

2. Carry Back and Carry Forward:

- When business credits (other than the foreign tax credit), exceed the taxpayer's gross tax for the year, the credits are carried back one (1) year and forward 20 years to use in years when the taxpayer has sufficient gross tax liability to use the credits.

Business Tax Credits



4.3 Foreign Tax Credit

Business Tax Credits

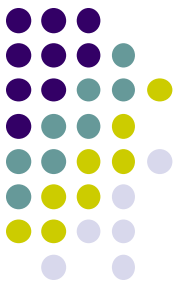


4.3 Foreign Tax Credit

- **Rationale:**

- U.S. citizens must pay U.S. tax on their worldwide income. However, when they generate some or all of their income in other countries, they generally are required to pay income taxes to the foreign country where they earned their income.
- Without some form of tax relief, taxpayers earning income overseas would be double-taxed on this income.

Business Tax Credits



4.3 Foreign Tax Credit

- **Options:** When a taxpayer pays income taxes to foreign countries, for U.S. tax purposes, they may treat the payment in one of three ways:
 1. Taxpayer may exclude the foreign earned income for U.S. taxation (up to \$102,100 in 2017) [**Gross Income**]
 2. Taxpayer may include the foreign income in their gross income and
 - a. deduct the foreign taxes paid as itemized deductions. [**Itemized deduction**], or
 - b. Claim a **foreign tax credit** for the foreign taxes paid.



Business Tax Credits

4.3 Foreign Tax Credit

- **Characteristics:**

1. Hybrid business and personal.
2. Nonrefundable.
3. Carry back one year and carry forward 10 years.

Business Tax Credits

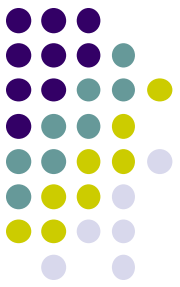


4.3 Foreign Tax Credit

- **IRS Publication:** See IRS Publication 514 “*Foreign Tax Credit for Individuals*” for more information about the foreign tax credit.

Credit Application Sequence





Credit Application Sequence

5.1 Rationale

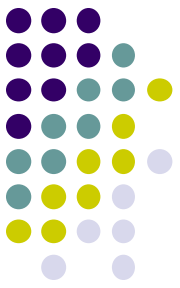
- Because the tax treatment of excess credits depends on the type of credit, it is important to identify the sequence in which taxpayers apply the credits when they have more than one type of credit for the year.



Credit Application Sequence

5.2 Rule

- When taxpayers have multiple credit types in the same year, they apply the credits against their gross tax in the following order:
 1. Nonrefundable personal credits
 2. Business credits
 3. Refundable credits.



Credit Application Sequence

EXHIBIT 8-12 Credit Application

Credit Type	Order Applied	Excess Credit
Nonrefundable personal	First	Lost
Business	Second	Carryback and carryover
Refundable personal	Last	Refunded

Credit Application Sequence



Example 11

Credit Application Sequence



Example 11

- Assume taxpayer's gross tax liability is \$369. The taxpayer is entitled to the following tax credits:
 - **\$800 nonrefundable personal tax credit**
 - **\$700 business tax credit**
 - **\$600 refundable personal tax credit**

What is the amount of taxpayer's refund or taxes due?

Credit Application Sequence



Example 11

- What is the amount of taxpayer's refund or taxes due?

Description	Amount	Treatment of Excess Credit
Gross Tax Liability	\$369	
Less:		
Nonrefundable personal credit	(369)	\$431 (\$800 - \$369) expires unused.
Business credit	0	\$700 carry back 1 year or forward 20 years (10 yrs. foreign tax credit)
Refundable personal credit	<u>(600)</u>	Fully refundable
Tax Refund	<u>\$600</u>	