PacificCPE

COURSE
34251A

Individual Income Tax Credits: Part 1

Get a solid grounding in individual income tax credits, from the foundational rules of federal credits to the nuances of nonrefundable credits and energy-related incentives. This course walks through how credits reduce tax liability, which credits are available to individual taxpayers, and how recent legislation has shaped energy-related credit opportunities. Ideal for practitioners who want a structured refresher or need to sharpen their understanding of credit mechanics before diving into more complex client scenarios.

CREDIT HOURS 2 | FIELD OF STUDY TAXES | EXAM QUESTIONS 10

Start Course ↓

Final Exam Copy ↓

LEARNING ASSIGNMENTS AND OBJECTIVES

Assignment

- Study the full course materials included here.
- Complete the review questions after each chapter.
- Answer 10 final exam questions.
- Final exam is scored immediately, 70% or better passes.
- Certificate of completion is available in your account.
- Failed exams can be retaken free of charge.

Course Objectives

- Recognize the attributes of federal income tax credits versus federal income tax deductions.
- Identify the difference between refundable, nonrefundable, and partially-refundable tax credits.
- Identify the unused federal income tax credits that may be carried forward to later years.
- Identify the requirements for claiming the Child Tax Credit.
- Recognize the applicability of the Lifetime Learning Tax Credit.
- Identifythehomeimprovements that qualifytaxpayers for the Energy Efficient Home Improvement Credit.
- Identify attributes of the Child and Dependent Care Tax Credit.
- Identify the taxpayer contributions that qualify for the Retirement Savings Contribution Credit.
- Recognize attributes of the Mortgage Interest Credit and the Foreign Income Tax Credit.
- Identify the homeimprovement sthatqualify tax payers for the Energy Efficient Home Improvement Credit.
- Recognize how to calculate the tax credit available for energy-efficient home improvements.
- Recall what is qualified energy property.
- Identify a clean vehicle eligible for an electric vehicle tax credit.
- Recall the rules governing electric vehicle purchase tax credits.

- Identify the maximum MAGI beyond which a taxpayer is ineligible for a new or previously-owned clean vehicle tax credit.

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INTRODUCTION

Governments have historically used a “carrot and stick” approach to encouraging individuals and businesses to behave in ways it deems desirable: tax credits for acting as requested and tax penalties for failing to behave as required. The U.S. government similarly promotes multiple forms of socially- beneficial actions—adopting children, becoming employed, providing funds for dependents’ education, and other socially-desirable activities—by offering incentives in the form of tax credits for engaging in them. This course examines the various tax credits that may be claimed by individual taxpayers and explains how each tax credit works, its eligibility requirements, limitations, phase-outs, etc. and, for refundable tax credits, their due diligence requirements.

Of the 161,336,659 federal income tax returns received in 2023 (2022 income) by the IRS, 61,831,870 taxpayers—about 38%—claimed one or more federal income tax credits amounting to a total of $154.8 billion. For a tax preparer that prepares 150 to 200 tax returns in a season, the numbers indicate that he or she is likely to encounter between 55 and 75 returns claiming income tax credits that average approximately $2,500.

Chapter 1: FEDERAL INCOME TAX CREDITS

Chapter Objective

After completing this chapter, you should be able to:

- Recognize the attributes of federal income tax credits versus federal income tax deductions.
- Identify the difference between refundable, nonrefundable, and partially-refundable tax credits.
- Identify the unused federal income tax credits that may be carried forward to later years.

INTRODUCTION

United States federal income tax law has its own lexicon. Thus, tax credits are refundable, partially refundable, and nonrefundable. In addition, certain tax credits may be carried forward, while others may be lost if the taxpayer is unable to use them in the year they are earned. Chapter 1 will define and discuss these issues concerning income tax credits.

TAX CREDITS VS. TAX DEDUCTIONS

Although tax credits and tax deductions both reduce taxes, they differ from one another in the way they accomplish the reduction. Tax deductions reduce taxes by reducing the taxpayers income. With reduced income, the income tax payable can normally be expected also to be reduced. In the case of a tax credit, however, the tax itself, rather than the income on which the tax is based, is reduced as depicted in the following example.

Consider the case of two taxpayers: one is eligible for a $10,000 tax credit and the other is eligible for a $10,000 tax deduction. Both file their tax return as married filing jointly and have adjusted gross incomes of $125,000, meaning they both are subject to a 22% federal income tax rate.

	$10,000 Tax Credit	$10,000 Tax Deduction
Adjusted gross income	$125,000	$125,000
Minus: tax deduction	NA	$10,000
Taxable income	$125,000	$115,000
Tax rate	22%	22%
Tax liability	$27,500	$25,300
Minus: tax credit	$10,000	NA
Taxes owed	$17,500	$25,300

So, income tax credits generally are more valuable to a taxpayer than income tax deductions of the same amount.

ALL TAX CREDITS ARE EQUAL BUT SOME ARE MORE EQUAL

With apologies to George Orwell, not all tax credits work identically. The U.S. tax code provides for a substantial number of tax credits, generally designed to meet various socially-desirable objectives. Tax credits are categorized as:

- Refundable tax credits that are treated as having been withheld from the taxpayer's income and payable to the taxpayer regardless of income tax liability; and
- Nonrefundable income tax credits that are payable to the taxpayer only to the extent of any income tax liability.

Nonrefundable tax credits—the tax credits that will be discussed in Chapter 2, Chapter 3—are tax credits that reduce taxpayers' income tax liability by the lesser of the credit or the tax liability. No part of a nonrefundable tax credit that exceeds the taxpayer's income tax liability will result in a refund of the balance of the credit. In short, a nonrefundable income tax credit requires that the taxpayer have a tax liability in the year the credit applies in order to be paid. A nonrefundable income tax credit in excess of the taxpayer's tax liability—with the exception of the adoption tax credit, the foreign tax credit, the energy efficient home improvement credit, and the residential clean energy credit—is not carried over to another year; it is simply lost.

NONREFUNDABLE FEDERAL INCOME TAX CREDITS

Nonrefundable federal income tax credits—credits that are limited to no more than the taxpayer's tax liability—include the following:

- Child Tax Credit;
- Adoption Credit;
- Lifetime Learning Credit;
- Residential Energy Credit;
- Child and Dependent Care Credit;
- Retirement Savings Contribution Credit;
- Mortgage Interest Credit; and
- Foreign Income Tax Credit.

Nonrefundable federal income tax credits will be considered in Chapter 2, Chapter 3. In so doing, we will examine the nature of the credit, its eligibility requirements, the amount of the benefit, and the applicable limitations imposed.

PARTIALLY REFUNDABLE FEDERAL INCOME TAX CREDITS

Unlike nonrefundable federal income tax credits that are lost if the taxpayer's federal income tax liability is less than the credit, refundable federal income tax credits are payable without being limited to no more than the taxpayer's federal income tax liability. In the case of partially-refundable credits, part of the credit may be lost unless the taxpayer has a tax liability but part is payable even though the taxpayer has no federal income tax liability. Partially-refundable federal income tax credits are those shown below:

- American Opportunity Tax Credit; and
- Additional Child Tax Credit.

FULLY-REFUNDABLE FEDERAL INCOME TAX CREDITS

As noted just above, refundable tax credits are tax credits that are treated as having been withheld from the taxpayer's income and which are refunded. So, refundable income tax credits are tax credits that are paid in their entirety to the taxpayer irrespective of the taxpayer's income tax liability. Refundable federal income tax credits are those shown below:

- Earned income tax credit;
- Health insurance premium tax credit; and
- Federal fuel tax credit.

Chapter 1 of course 34252B, will consider both partially-refundable and fully-refundable federal income tax credits. It will examine the nature of the credit, its eligibility requirements, the amount of the benefit, and the applicable limitations imposed.

TAX CREDIT CARRY FORWARD

Federal income tax credits, in addition to being refundable, nonrefundable or partially refundable may sometimes be carried forward to subsequent years. Since refundable credits generally are paid out fully despite the taxpayer's tax liability, there is usually nothing to be carried forward; certain nonrefundable credits, however, may be carried over to future years. The unused nonrefundable tax credits that may be carried forward are:

- The adoption tax credit;
- The foreign tax credit;
- The residential clean energy tax credit; and
- The energy efficient home improvement tax credit.

Adoption Tax Credit May Be Carried Forward

When a taxpayer adopts a child, he or she may be able to claim a tax credit for some of the costs associated with the adoption. Because the adoption tax credit is nonrefundable, i.e., available only to taxpayers with a tax liability, no refund of the amount of the unused tax credit in excess of the claimant's tax liability is available. Instead, the balance of the adoption tax credit exceeding the taxpayer's tax liability may be carried forward for up to five years.

Foreign Income Tax Credit May Be Carried Back and Carried Forward

If a taxpayer can't claim a credit for the full amount of qualified foreign income taxes he or she paid or accrued in the year, the taxpayer is allowed a carryback and/or carryover of the unused foreign income tax. Except that no carryback or carryover is allowed for foreign tax on income included under IRC §951A,1 i.e., foreign income received as a United States shareholder of a controlled foreign corporation, the taxpayer can carry back the unused foreign tax for one year and then carry it forward for 10 years.

Credits for Energy Efficiency

Home Energy Tax Credits are available to taxpayers who purchase energy-efficient equipment to reduce their energy consumption. The Residential Clean Energy Tax