STATE TAX REFUND - Analysis and Tax Planning

(From the 2001 Wisconsin Tax Guide)

Tax Planning

Introduction

How many times has a taxpayer said, "Why should I have to pay tax on my state refund? I've already paid tax on it!"? The answer is an obvious one for a tax preparer, who attempts to explain the concept of previous deductions and subsequent recovery to a skeptical taxpayer. Some unconvinced taxpayers insist on not getting a state refund, so as not to pay tax on it the following year. Some of these taxpayers may indeed be avoiding additional taxes, but not for the reason they think.

There are pros and cons applicable to the receipt of a state tax refund by a taxpayer. Most of the pros are obvious, but many of the cons are not so obvious. Since this area of planning has not been addressed elsewhere, the author will cover it in more detail here.

Advantages to receiving a state tax refund:

✓ Taxpayers enjoy receiving refunds, plan special purchases, vacations, etc.
✓ Some taxpayers think of the extra withholding as an enforced savings. (If they had bigger paychecks during the year, they would spend it.)

Disadvantages to receiving a state tax refund:

✓ It costs the taxpayer investment dollars.
✓ It costs the taxpayer tax dollars.

It is the second disadvantage that will be explained here in detail. There are several situations that cause taxpayers to pay additional tax merely because they get a state tax refund. A state refund from the State of Wisconsin could be due to several factors. Before considering reasons for avoiding refunds, let us consider how much of a state tax refund is taxable.

Character of a Wisconsin state tax refund:

✓ Refund of excess withholding/estimates - taxable on Federal return to extent deducted on prior year Schedule A
✓ Earned Income Credit - not taxable
✓ Homestead Credit - not taxable
✓ Farmland Preservation Credit - fully taxable on Wisconsin return, taxable on Federal return to extent farm property taxes are deducted *(See ... Chapter 3 - INCOME & DEDUCTIONS - REFUND)*
✓ Farmland Tax Relief Credit - fully taxable on Wisconsin return, taxable on Federal return to extent farmland property taxes are deducted *(See ... Chapter 3 - INCOME & DEDUCTIONS - REFUND)*
✓ Nonrefundable credits (Property Tax Credit, Itemized Deduction Credit, Married Couple Credit, etc.) - all are allowable reductions to tax liability . . . to extent deducted, they need not be added back to otherwise Federally-taxable refund
✓ Increases to net tax (IRA penalty, endangered resource donation, sales/use tax) - taxable on Federal to the extent the refund was reduced.

✎ **EXAMPLE** Taxpayer received refund check of ...	$2000	
Prior year IRA penalty was ...		$<u>1000</u>
Taxable state refund ...		$3000 (2000 + 1000)

☺ **TIP** Minimum Tax is not added back, not taxable.

Form 1099-G

Wisconsin receives computer "tapes" from IRS indicating which taxpayers itemized on their Federal return. All of the itemizers that received a state tax refund (as adjusted) from Wisconsin are sent Form 1099-G. In determining a reportable state tax refund on Form 1040 (line 10) many possible adjustments to the "refund check" need to be considered.

These are the **<u>additions</u>** made to what the taxpayer actually received:

✓ Sales/use tax
✓ Endangered resource donation
✓ IRA/retirement plan penalty
✓ Late filing penalties and interest
✓ Overpayment credited to next year's tax estimate
✓ Underpayment interest and late filing penalty

EXAMPLE
$ 500 Actual refund check received by taxpayer
+ 200 Penalty for early withdrawal of IRA
$ 700 = TAXABLE REFUND

The following are **subtractions** made to the taxpayer's actual check:

- ✓ Homestead Credit
- ✓ Earned Income Credit
- ✓ Farmland Preservation Credit *
- ✓ Farmland Tax Relief Credit *

* Not reported as a "state tax refund", but may be partly taxable to Federal, 100% taxable to Wisconsin.

EXAMPLE
$3000 Actual refund check received by taxpayer
-2000 Farmland Preservation Credit included
$1000 = TAXABLE REFUND

☹ **TRAP** Don't be too quick to eyeball and use the number at the bottom of Form 1 from the prior year when determining the taxable state refund! Besides the additions and subtractions previously described, Wisconsin may have made an adjustment to the return as originally filed (about which the taxpayer neglected to tell you). When in doubt, use Form 1099-G!

Situations where a taxable state tax refund can cause additional tax:

Educational Savings Bond Exclusion – Form 8815

Depending upon filing status, the exclusion in 2001 is phased out between $55,750-$70,750 for a single taxpayer and between $83,650-$113,650 for MFJ. A $1000 state tax refund will cause approximately $67 of the Federal exclusion to be disallowed. The additional tax paid on Federal would be about $19.

This affects Federal only; it has no impact on the Wisconsin return.

Rental loss deduction

For taxpayers with income ranging from $100,000 - $150,000, a rental loss will be reduced $1 for every $2 of extra income, including state tax refunds, due to the passive activity loss limitations. A $1000 state refund can cause tax to be paid on an extra $500 of income for both Federal and Wisconsin. The unallowed $500 loss can be carried over, but the immediate deduction is lost.

Taxable Social Security

State tax refunds are also included in income that determines the phase-in for Federal taxability of social security benefits. Up to 85% of social security benefits may be taxable to Federal. A state tax refund of $1000 can cause up to $850 of additional taxable social security on the Federal return. On Wisconsin, up to 50% of social security benefits could be taxable, however, state tax **refunds can be excluded** from the computation of taxable social security benefits for Wisconsin purposes if the proper election is made.

Deductible IRA's

State tax refunds are included in the income that determines the phase-out for deducting IRA's. A state tax refund of $1000 means that $200 less of an IRA is deductible on the Federal and Wisconsin tax returns for taxpayers in the IRA phase-out range.

Student Loan Interest

This "above-the-line" deduction in 2001 is phased out from $40,000-$55,000 for single and HH ($60,000-$75,000 for MFJ). A $1000 state tax refund could cause $67 less of the interest to be deductible for Federal and Wisconsin. This would result in additional tax of about $19 for Federal and $5 for Wisconsin.

Medical expense deduction

The increase in AGI causes several areas on Federal Schedule A to be adversely affected. A $1000 state refund can cause $75 (7.5% x 1000) less of an allowable medical deduction. This same $75 medical expense is therefore also not available for the 5% Itemized Deduction Credit on Wisconsin.

Casualty loss deduction

A $1000 state refund reduces the Schedule A loss deduction by $100 (10%) on the Federal return. Such losses are not deductible on Wisconsin; so there is no effect on the state return.

Miscellaneous Deductions

A $1000 state refund reduces this deduction by $20 (2%) on the Federal return. Miscellaneous deductions are no longer applicable to Wisconsin.

Itemized Deductions

Higher income taxpayers are subject to a phase-out of itemized deductions when AGI exceeds a certain dollar amount. Most itemized deductions are reduced by 3% of the amount by which AGI exceeds $132,950. A $1000 state tax refund could cause $30 of deductions to be disallowed. This affects Federal only; it has no impact on the Wisconsin return.

Personal Exemptions

Higher income taxpayers are subject to a phase-out of Federal personal exemptions when AGI exceeds a certain dollar amount. All personal exemptions claimed are reduced by 2% of the amount by which AGI exceeds $132,950 for a single taxpayer ($199,450=MFJ, $166,200=HH). A $1000 state tax refund could cause $20 from each exemption to be disallowed. This affects Federal only; the deduction for personal exemptions on the Wisconsin return are not subject to a phase-out.

Child Care Credit

Additional income can cause the percentage to be decreased. Child care credits vary when AGI falls between $10,000 and $28,000. A $1000 state tax refund could affect the credit by 1%. Assuming a maximum expense of $4800, the ultimate effect would be $48.

Schedule R Credit

The Federal elderly/disability credit is also affected by AGI. For each $2 of income, the credit is reduced by $0.15 ($1 x 15%). A $1000 state refund could affect the credit by as much as $75.

Child Tax Credit

There is a $10,000 phase-out range in 2001 for each eligible child, starting at $75,000 for a single taxpayer and HH ($110,000 for MFJ). The inclusion of a $1000 state tax refund in income would result in a credit loss of $50.

This affects Federal only; it has no impact on the Wisconsin return.

Educational Credits

In 2001, for single taxpayers with income ranging from $40,000-$50,000 (MFJ $80,000-$100,000), the Hope and Lifetime Credits are subject to a phase-out. A $1000 state tax refund will cause $100 of one of the credits to be lost.

This affects Federal only; it has no impact on the Wisconsin return.

Adoption Credit

The credit is phased out between $75,000-$115,000 of income in 2001. A $1000 state tax refund could cause $25 in credits to be disallowed for the tax year. Unused credits are carried forward. Wisconsin’s subtraction modification for adoption expenses is not subject to a phase-out.

Earned Income Credit

Income added to an existing AGI range of approximately $13,100 - $32,121 (for 2001) will reduce the combined Federal & Wisconsin EIC anywhere from about 18-30%. Assuming three dependent children, a $1000 state refund could reduce the combined Federal & Wisconsin EIC by about $300.

Wisconsin Tuition Subtraction

The phase-out range for a single taxpayer is from $50,000-$60,000 (MFJ: $80,000-$100,000) and is based generally on Federal AGI. A Federally taxable state tax refund of $1000 could cause $100 less of a subtraction for a single taxpayer, resulting in $7 of extra tax.

Form 1NPR Prorated Deductions and Credits

The state tax refund is entered in column A and becomes part of Federal AGI. It is not entered in column B, Wisconsin income. The higher Federal income is, the lower the standard deduction (before proration). The proration ratio is based on the ratio of Wisconsin income to Federal AGI. The lower the ratio, the less standard deduction and personal exemptions allowed and a smaller proration of credits (property tax/rent, itemized deduction) . . thereby increasing the tax liability.

✎ **EXAMPLE** $10,000 of Wis income
$20,000 Fed AGI (w/o a refund).
Ratio = **.5000** (10,000/20,000).
Prorated standard deduction for a single taxpayer is $3008.
Prorated personal exemption for one person is $300.
Credits of $500 are prorated down to $250.

With a $1000 state refund added to Federal AGI, the ratio is **.4762** (10,000/21,000).
Prorated standard deduction is now $2865.
Prorated personal exemption is now $286.
Prorated credits are down to $238.
Total tax difference = $21 ($9 tax, $12 credits).

Form 1NPR Tax Brackets

A Tax Computation Worksheet is used to compute tax for those filing Form 1NPR. Tax Brackets are prorated based on the ratio of Wisconsin AGI to Federal AGI. The lower the ratio, the sooner the higher tax bracket is reached.

Other Areas Affected Negatively

- ✓ Income limitation levels for Charitable Contributions reached more easily
- ✓ Higher income could reduce the amount of Foreign Tax Credit allowed (Federal only)
- ✓ Higher income could cause more of various Federal Business Credits to be used, resulting in less to be carried forward
- ✓ Income limitation levels for deducting Section 179 Expense reached more easily

Overlaps:

It is possible that two or more of the situations listed above could happen to the same taxpayer, compounding the detrimental effect. For example ...

- ✓ One spouse is retired and receiving social security benefits, the other spouse is working and contributing to an IRA.
- ✓ Another common overlap would be a person claiming Child Care Credit **and** eligible for Earned Income Credit.

Summarizing the Negative Effects of Receiving a State Tax Refund

The table below illustrates the increase in tax that could result from the inclusion of a taxable state refund in Federal income. A $1000 state tax refund on Form 1040 can cause Federal taxable income to be increased by much more than the $1000. It can also reduce Federal credits because of the phase-out ranges. In many cases, the Wisconsin tax return will not be affected. This is because the phase-outs apply only to Federal credits or Federal deductions. (n/a = not applicable)

✎ **EXAMPLE** Taxable social security could increase by $850 (2nd column) if an extra $1000 state refund is included in income. This results in extra Federal tax of $238 (4th column). It has no effect on Wisconsin (5th column) if the taxpayer elects to exclude the state tax refund from the calculation of taxable social security for Wisconsin purposes.

✎ **EXAMPLE** Federal Earned Income Credit of $210 (3rd column) could be lost if a $1000 state tax refund is included in Federal income. This, of course, results in increased Federal tax liability of $210 (4th column) and Wisconsin tax liability of $90 (5th column). Note: Wisconsin EIC is a flat percentage of Federal EIC. So even though Wisconsin income is not the same as Federal AGI, this difference will not affect Wisconsin EIC.

For each item in this summary table, assume the following ...

- ✓ Taxpayer is fully affected by the specific phase-out range
- ✓ Federal tax bracket is that which is most common for the income that the phase-out affects (usually 28%-31%)
- ✓ For all other tax rates, we chose 28% for Federal and 6.5% for Wisconsin

$1000 State Tax Refund Taxable on Federal	Increased Federal Taxable Income	Reduced Federal Credit	Increased Federal Tax Liability	Increased Wisconsin Tax Liability
INCREASED INCOME				
Educational Savings Bond Exclusion	$67		$19	n/a
Rental Losses (unused losses carried over)	$500		$155	$33
Social Security Benefits	$850		$238	$33 ($0 if exclude)
REDUCED ADJUSTMENTS				
Deductible IRA	$200		$56	$13
Student Loan Interest	$67		$19	$4
REDUCED ITEMIZED DEDUCTIONS				
Medical Expenses	$75		$21	$4
Casualty and Theft Loss	$100		$28	n/a
Miscellaneous Deductions	$20		$6	n/a

Phase-Out of Total itemized Deductions	$30		$9	n/a
REDUCED PERSONAL EXEMPTIONS				
Phase-Out (assume two children)	$40		$12	n/a
REDUCED FEDERAL CREDITS				
Child Care Credit (assume two children)		$48	$48	n/a
Credit for Elderly or Disabled		$75	$75	n/a
Child Tax Credit		$50	$50	n/a
Hope Credit (assume two children)		$200	$200	n/a
Lifetime Learning Credit (one person)		$100	$100	n/a
Adoption Credit (unused is carried over)		$25	$25	n/a
Earned Income Credit (assume 3 children)		$210	$210	$90
WISCONSIN SUBTRACTION				
Deduction for College Tuition				$7

What other factors should be considered in planning for a state tax refund?

Time value of money

Less withholding during the year (therefore a lower refund) could, if invested, put more money in the taxpayer's pocket. *(See below)*

Change in tax brackets from year to year

If in the 28% tax bracket for year 1 and 15% for year 2 . . . extra state withholding could be deducted at 28% in year 1, with the refund the following year (year 2) taxed at only 15%.

Adjusting Federal refund to make up for Wisconsin

If it will be more beneficial to eliminate a state tax refund, increase the Federal refund so that the bottom line is similar. Federal refunds will not cause any additional tax to be paid.

Bigger Paychecks vs. Bigger Refunds

Preparers and taxpayers are usually aware of the possible financial "benefit" when refunds are avoided due to a decrease in withholding and a subsequent increase in paychecks. How much of a difference does it make?

✎ **EXAMPLE** Compare a $3000 refund received on March 31 vs. no refund, with the accumulated extra amount from the paychecks being invested at 6% simple interest. An extra $3000 in take-home pay spread out throughout the year will grow steadily from $0 on January 1 to $3000 on December 31 during the tax year for which the refund might have been computed.

Interest earned for the year = $90. Another $45 interest would be earned on the same $3000 from the end of the year until the time a refund might have been received (12/31 to 3/31). Total interest earned when foregoing a $3000 refund = $135 (90 + 45*). (See following* ***"TIP"*** *for analysis)*

☺ **TIP** Rule of thumb: **Refund x Interest Rate x .75. = Interest saved**

Example: $3000 x 6% x .75 = $135

☹ **TRAP** Axiom: Generally, the size of a refund is directly proportional to the taxpayer's state of satisfaction. In other words, those taxpayers who don't get the refunds they're used to getting may be dissatisfied!