

Accredited Tax Advisor (ATA)

Preparatory Course

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Chapter 7

TAX CREDITS

LEARNING OBJECTIVES

After reviewing this chapter, you should be able to:

- Explain the difference between a tax deduction and a tax credit
- Differentiate between refundable and nonrefundable tax credits
- Understand how a variety of tax credits are determined
- Identify who is eligible for certain types of tax credits
- Explain the rules for a variety of tax credits, including credits related to education, eligible dependents, adoption, foreign tax, retirement savings contributions, residential energy, and more

Tax liability is figured by applying tax rates to taxable income and adding other taxes to reach a total tax amount. But the total tax amount is not the final tax bill. Total tax is reduced by certain tax payments, and by the specific tax credits discussed in this chapter.

OVERVIEW OF TAX CREDITS

Tax credits are dollar-for-dollar reductions of the total tax. This means a \$1 tax credit reduces the tax bill by \$1, regardless of a taxpayer's tax bracket. Just to demonstrate the contrast between a tax deduction and a tax credit, take the following example of a taxpayer in the 22% tax bracket who pays \$1,000. If the \$1,000 is deductible, the tax savings is \$220 ($\$1,000 \times 22\%$). But if the \$1,000 is a tax credit, the tax savings is \$1,000 (the full amount of the credit regardless of the taxpayer's tax bracket).

Congress creates tax credits to incentivize certain actions or investments, or to help certain types of taxpayers. There are two types of tax credits:

- **Nonrefundable credits.** These are tax credits that can be claimed to the extent of tax owed. All tax credits are nonrefundable unless they are specifically refundable, as explained next. Examples of nonrefundable credits include:
 - Adoption credit
 - Child and dependent care credit
 - Foreign tax credit
 - Lifetime learning credit
 - Retirement savings contribution credit
 - Business-related tax credits, such as the credit for small employer pension plan start-up costs, the credit for employer-provided family and medical leave, and the credit for small employer health insurance premiums.
- **Refundable credits.** These are credits that can exceed tax liability. In effect, a taxpayer can receive a refund in excess of the amount of taxes he or she paid. Some refer to this as a negative income tax because it produces government assistance to eligible low- and middle-income taxpayers. Refundable credits are all other credits other than nonrefundable credits. They include:
 - Earned income credit
 - Child tax credit (the additional child tax credit portion)
 - American opportunity credit (only a portion)
 - Premium tax credit
 - Health coverage tax credit
 - Credit for excess Social Security tax withheld

Most, but not all, credits are figured on a separate form or schedule before being entered on a schedule for additional credits and payments or directly on the return.

Some tax credits are entered directly on the tax return on lines specified for this purpose. Most credits, however, must be entered on a schedule for additional credits and payments, which is then attached to the return.

CORPORATION FORMATION

A corporation is formed by filing articles of organization or incorporation in the state where those starting the corporation want it to be organized. If the corporation has no more than 100 qualifying shareholders, the shareholders can elect S corporation status.

A corporation formed as a limited liability company (LLC) with two or more members can elect to be classified as a partnership, a C corporation, or an S corporation (provided that all other conditions for S corporation status are satisfied). If the LLC has only one member, it can elect to be treated as a C corporation, an S corporation, or a disregarded entity.

Operating a business as a corporation generally offers the shareholder(s) of the business more protection from creditors than operating it as a sole proprietor or a general partnership.

Some of the basic differences in the choice of entities are presented in the following chart.

Choice of Entity Comparison					
Attributes	C Corporation	S Corporation	LLC	Partnership	Sole Proprietorship
Eligible owners	Any number of individuals or entities	No more than 100 eligible shareholders	Any individual or entity	Two or more individuals or entities	One individual
Classes of ownership	Multiple classes allowed with differing voting rights and preferences	Only one class allowed, but can vary voting and non-voting rights	Multiple classes allowed with different rights	Multiple classes allowed with different rights	N/A
Owner liability	Limited	Limited	Limited	General partner, unlimited Limited partner, limited	Unlimited
Taxation	21% flat tax rate, net operating losses carried forward indefinitely	Income and losses pass through to shareholders and reported on their individual returns. Tax is paid at shareholders' personal tax rates.	Depends on the tax structure selected for the entity. A single-member LLC that has not elected to be treated as a C or S corporation is treated as a sole proprietorship.	Income and losses pass-through to partners and reported on their individual returns. Tax is paid at partners' personal tax rates. Income may be subject to self-employment tax.	Income is reported on individual tax return and subject to tax at the owner's personal tax rate. Income is also subject to self-employment tax.
Payments to owners	Owner-employees and officers may take reasonable compensation that is deductible by the corporation. Dividends paid to owners are not deductible by the corporation, and are subject to dividend rates on the individual owner's tax return.	Owner-employees must take reasonable compensation, and officers may take compensation that is deductible by the corporation. Shareholder distributions may be taken tax-free, provided the shareholder has basis.	It depends on the tax structure chosen for the entity.	Partners are not allowed to take wages, but may receive guaranteed payments that are deductible by the partnership and subject to self-employment tax on the individual partner's tax return. Partners may receive distributions tax-free.	Owner is not allowed to take compensation. All draws are tax-free.

The IRS is concerned with unreasonably high compensation paid to shareholder employees. This is because excess compensation absorbs taxable income while it is actually a disguised dividend. Compensation is considered reasonable based on:

- Employee qualifications
- The nature, extent, and scope of the employee's work
- The size and complexity of the business
- Prevailing general economic conditions
- Prevailing rates of compensation for comparable positions in comparable concerns
- The salary policy of the taxpayer as to all employees
- Previous years' compensation
- Comparison of salaries paid with the gross income and net income
- Comparison of salaries with distributions to stockholders

As with the determination of whether a contribution is debt or equity, no one factor dominates the decision for reasonable compensation.

While it is not the tax preparer's responsibility to determine whether the compensation paid to a shareholder employee is reasonable, the preparer should inform the owner(s) that the IRS has in some cases reclassified unreasonably high compensation as a dividend, which can cause a significant tax impact on the corporation.

Salaries and Wages

Line 13 reports the salaries and wages of other employees, less any amounts reported elsewhere. Accrued salaries and wages for non-related party employees may be deducted in the year accrued if they meet the all-events and economic performance test. However, a tax regulation specifically requires that year-end accruals for compensation, bonuses, vacation pay, and severance pay must be paid within 2½ months after year-end. If not paid within that time period, they are deductible when paid.

For accrued vacation to be deductible, the vacation time must be vested. This means that not only is the employee allowed to carry over the unused vacation time from one year to the next, but also the employer is obligated to pay any unused vacation time to the employee upon termination.

Bad Debts

Line 15 reports bad debt expense. Cash-basis taxpayers should never have bad debt expense related to normal sales reported on this line. Under the cash basis, outstanding accounts receivable are not included in income, so a deduction cannot be claimed when a customer does not pay.

Accrual-basis taxpayers may report bad debt expense in the year the receivable is considered worthless. To be deductible, the taxpayer must have taken reasonable steps to collect the debt.

This may differ from the approach used for financial reporting purposes. An accrual-basis taxpayer that also reports U.S. GAAP financial statements may be recording bad debt expense based on estimates. The tax preparer should inquire if any accounts receivable were actually written off.

REVIEW QUESTIONS

1. Ownership of a C corporation:
 - a. Is limited to 100 or less eligible shareholders
 - b. Is unlimited as to the number of individuals or entities
 - c. Requires two or more individuals or entities
 - d. Is limited to one individual

2. Which of the following is a factor that shows advances to a corporation are debt?
 - a. The advances made by stockholders are in proportion to their stock ownership.
 - b. The corporation would not have been able to borrow elsewhere.
 - c. The corporation used the advances to meet the daily operating needs of the company.
 - d. There is no fixed maturity date of the advance.

3. Form 1120 is due on what date for a calendar-year C corporation, without regard to extensions?
 - a. March 15
 - b. April 15
 - c. September 15
 - d. October 15

4. ABC Corp. is a new C corporation. ABC wants to have a December 15 year-end. Which of the following is true regarding this year-end choice?
 - a. December 15 may not be used as a year-end
 - b. December 15 may be a fiscal year-end.
 - c. December 15 is a choice for a 52-53-week year.
 - d. December 15 is a calendar year since the year-end is in December.