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Why Paying Card Debt Can Trump 2010 Tax Tips

All that tax advice won't help much compared to pay down card debt

By Jen A. Miller

It's almost that time of year -- no, not for sleigh bells, menorahs and eggnog -- but when we'll be inundated with advice about "smart" financial moves to make before 2011 to reduce your 2010 tax burden.

Why paying card debt can trump 2010 tax tipsBut before you start stashing cash in retirement funds or making extra mortgage payments, if you're carrying balances on credit cards, you might save more money by paying down that debt first.

"I hate to make a flat generalization because it's really going to depend on the terms of your credit card and what rate you're getting, but from a cash management perspective, I would pay off credit cards first," says Melissa Labant, tax manager of the American Institute of CPAs.

That's because deductions rarely equal mega tax savings, and knocking out debt -- especially debt on high interest credit cards -- will give you more cash down the line.

Here's a list of four tax scenarios to help you decide.

1. Pay to deduct. You have two options when taking deductions for your taxes. You can take the standard deduction, or you can itemize.

The standard tax deduction is a straight dollar amount based on how you file:

Single: $5,700
Single blind/elderly: $1,400
Married filing jointly: $11,400
Married filing jointly blind/elderly: $1,100
Head of household: $8,400
Head of household blind/elderly: $1,400
Married filing separately: $5,700
Married filing separately blind or elderly: $1,400

Most year-end tax advice is about maximizing deductions for people who itemize (whose deductions add up to an amount higher than the standard deduction).

Some advice you'll hear if you itemize: Make an extra mortgage payment so you can deduct that extra interest; make an extra student loan payment for more interest deductions; or donate money to a charity for the deduction.

While these things aren't bad advice, it's not necessarily the best way to maximize your cash if you have credit card debt.

"Deductions only reduce your taxable income, which determines your tax bracket," says Kelly Phillips Erb, a tax attorney and author of taxgirl.com. "The savings are illusory. It's a small difference."

Deductions don't reduce your tax burden dollar for dollar. They'll reduce your taxable income and maybe will drop you down a tax bracket. If you get to a lower tax bracket, you pay less.

The most you are going to save when moving from one bracket to another is 10 percent. Moves between most brackets represent only a 5 percent difference.

Plus, in the case of prepaying mortgage and student loans, you're only shifting your deductions. Make 13 mortgage payments this year so you can write off 13 months of interest? That might knock you down a tax bracket this year.

"You're just changing the timing of the deductions, rather than changing the actual value of the deductions," says Phillips Erb. "What you've effectively done is increase your tax bracket for the next year unless you do it every year."

Best option: Pay down credit card balances first.

Here's why: Let's say you have an extra $1,500 at the end of the year. For the purpose of this exercise, we'll assume your mortgage payment is also $1,500.

If you use that to make an extra mortgage payment, you can deduct only the interest of that mortgage payment from your taxable income -- not the full $1,500. This may or may not drop you down a tax bracket. If it does, you'll be taxed at a lower interest rate. If it's not enough to move you to another bracket, making this move has no effect on your tax bill.

But let's say you also have a credit card with a 14.37 percent interest rate (which is the national average APR on new credit card offers as of Oct. 21) and a $1,500 balance. Knock out the credit card debt and you can save a year's worth of $135 payments plus $120 in interest costs -- provided you don't charge anything additional on the card. (Use the CreditCards.com payment calculator to see how much you could save on your debt.)

Get rid of the interest-accruing credit card debt first rather than doing something that might or might not drop you down a tax bracket.

2. Add to retirement. Roth IRAs are fueled with after-tax money, so you won't get any deductions for making extra payments here. However, any money you add into a 401(k) can be deducted from your taxes, up to the $16,500 contribution limit.

Tax attorney

We don't want you to NOT save as much as you can for retirement, but you're still playing the deduction game. Yes, you could put enough extra cash into your 401(k) that you'll have enough deductions to drop you down a tax bracket. But you'll only be dropping down to a lower taxable rate.

Best option: Pay down high interest credit cards first.

Here's why: Let's stick with the same $1,500 example. If you throw that money into your 401(k), you can deduct $1,500 from your taxable income. This may or may not drop you down a tax bracket. If it does, you'll be taxed at a lower interest rate. If it's not enough to move you to another bracket, making this move has no effect on your tax bill.

We're not saying to not contribute to your 401(k) -- especially if your employer matches part of your contributions.

But, if you have any money above and beyond what's taken out of your paycheck, pay down the debt. And once you pay off your credit cards? Then throw that money you were dumping toward your debt into your 401(k). Get the peace of mind (and no more interest) of zero credit card balances first.

3. Prepay college tuition. Got a tuition bill due for next spring's semester? If you pay it in 2010, you can qualify for the American Opportunity Tax Credit.

"This would be one situation where I would think about pre-paying something a month in advance in order to get that tax credit," says Labant.

Credits are different than deductions. Deductions can drop you down a tax bracket to reduce the percentage of taxes you pay. Credits are a dollar for dollar deduction off your tax bill.

With the American Opportunity Tax Credit, you can take a credit of 100 percent of the first $2,000 of education expenses, and then 25 percent of the next $2,000 for a maximum of $2,500 per student.

You can take the credit if your modified gross income is $80,000 or less if filing as single or head of household, or $160,000 or less for married couples filing a joint return.

Best option: If you qualify for the American Opportunity Tax Credit, prepaying tuition might work for you.

Here's why: If, for example, your tax bill would normally be $10,000, pre-paying tuition to qualify for the credit would drop you down to $7,500 if you qualify for the maximum credit. If you normally get a tax refund check, and you don't owe any additional taxes this year, that $2,500 will be added to your check, which you can then throw at your credit card balances.

Take the credit if you can, and file your tax return in January so you'll get your tax refund check back ASAP and can turn it into paying down your credit card balances.The credit was part of the 2009 stimulus package, and although President Obama has asked Congress to make it permanent, it currently is slated to expire at the end of 2010.

4. Change your withholdings. If you have a full-time job, you should have filled out a W-4 form, which tells your company's accounting department how much money to withhold from your paycheck check, which is sent directly to the IRS. This way, you don't have to pay all your federal income taxes in a lump sum in April.

If you have your company take out too much, you get any excess after you file your taxes. That's what makes up your tax refund.

It might feel good to get that big check, but it's not your best money move.

"Receiving a large refund from the government is similar to giving the government a non-interest bearing loan," says Michael Specht, CPA and member of the Metis Group CPAs LLC of New York City. "If someone has credit card debt where they are paying interest on the balance due, it is even more important to reduce their tax withholdings to the optimal level, and increase their current cash flow in order to pay down as much of that debt as possible."

The "optimal level" would be withholding just enough that you don't get a huge refund nor owe any money. To do that, go to your employer and get a copy of your W-4. Then fill out a new W-4 and claim a higher number of allowances.

The IRS has a handy calculator to help you figure out what allowances you can take. Make sure you have your last pay stub and know the dollar amount of any bonuses, unemployment checks, contributions to retirement plan, Flexible Spending Account (FSA) or Health Savings Account (HSA), or nonwage income such as alimony and dividends that you'll receive this year.

Best option: If you got a whopping tax refund check this year, change your withholdings so that less money is given to the government as an interest free loan.

Then take that money and throw it at your credit card balances -- and leave the year-end tax tips for whenever you've paid off that final credit card bill.

On a final note: If you find that after taking these steps that you are in the lucky position to still receive a nice tax return, using that cash to pay down any credit card balances is one of the wisest financial moves you can make.