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How Can I Make The Most Of My Tax Refund?

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A weekly question/answer column

How Can I Make The Most Of My Tax Refund?

Barbara Rowe* answers:

April 18, 2002

If you expect a tax refund this year, you are not alone. Last year, 74 million Americans received refunds. According to the Internal Revenue Service, refund amounts average \$2,091 this year, compared to last year's \$1,743.

There are many ways to spend your tax refund. Consider these suggestions to make the most of it.

- Invest in an Individual Retirement Account (IRA). Options include a Roth IRA or a traditional IRA. A traditional IRA allows you to receive an up-front tax break on the money you put in. With a Roth IRA, you must pay taxes on the money you contribute, but you can withdraw principal and interest tax free. This year you can put up to \$3,000 in a Roth. If you are over 50, you can invest \$3,500, assuming your income does not exceed the annual income thresholds.
- Put your money into a 529 College Savings Plan. This is a good place to park extra dollars for parents who are putting money away for their child's college tuition. This state-sponsored tool does not have income requirements, and you can stash up to \$10,000 tax free in any given year.
- Consider adjusting your withholding. If you are getting a \$2,000 refund, you are giving the government an interest-free ride on your money. By adjusting your tax withholding, you will receive more money in your paycheck. You can use this money to invest as you wish, or to reduce debt.
- Pay off credit card debt. If you don't have a credit card balance, you're in great shape. If you do, consider investing your refund in something that will provide a guaranteed return of 14 percent or more. By applying your refund to your credit card balance, you can save thousands of dollars in interest. There are many consumers who don't believe their refund will make much of a dent in their overall debt. But they are wrong. Consider this:

Many economists point to signs that the economy is rebounding and with it, the Fed may raise interest rates as early as this summer. This is good news for savers, but it will raise the cost of debt. About half of all credit cards have variable interest rates, which means they move up or down depending on current interest rates. Many creditors use a formula tied to the prime rate, which is the rate banks charge their best customers. The prime usually moves up when the Fed pushes rates up. Most creditors have set limits on how low interest rates can go, so card holders stopped benefitting from falling rates months ago. If the prime moves higher, you can expect the

fees on your variable rate credit cards to go up, too.

Late fees are climbing for card holders with large balances. Several big issuers have increased late fees for card holders with balances of \$1,000 or more. While the average late fee is \$28.58, several issuers are charging up to \$35 for customers whose balance exceeds \$1,000.

The cost of tarnished credit is increasing. Most consumers know that a blemished credit report can make it difficult to get a credit card or buy a house. But auto insurers are increasingly using consumers' credit scores to calculate the cost of premiums for their policies. If you fall behind on your credit card payments, you could end up paying more in auto insurance, in spite of the fact that you may have an impeccable driving record. Home insurers are also using credit scores when pricing insurance.

Even if your refund isn't enough to eliminate your credit card debt, it can provide a good starting point. When you see your balance drop significantly, that might motivate you to pay the card off more quickly.

If your balance is spread among several credit cards, use your refund to pay one or more of them off. This will reduce the number of cards you have to juggle, making your debt more manageable. Once you've paid one card off, close the account.

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