M&Y INTERNATIONAL FINANCIAL SERVICES NEWSLETTER

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How unemployment can really drive up your tax bill

Back in September of 2015, I lost my job and decided to take unemployment benefits for the first time in my life while I looked for a new one. Even the significantly reduced income that the unemployment benefits provided was a needed cushion since we'd closed on a new home the same week I lost my job. I'd crunched the numbers, and taking the benefits was going to be a better alternative than using money from our emergency fund (which was tied to the markets and had fallen significantly just the month before).

"Credits are great because they lower your tax liability dollar for dollar"

What I didn't account for was taxes, so when I received that 1099-G form from the unemployment commission last spring, I was confused. I owed income tax on the benefits I'd received, which were already just 25% of what my income had been? Seriously? It felt unfair that my employers had been paying into unemployment insurance all these years so I'd have the benefit if I ever needed it, and now the government was going to take a good-sized chunk of that money I needed to keep our family afloat.

After a couple of hours of grumping, I bucked up, talked to our accountant and moved on. Of course, it was my fault that I didn't ask the right questions and do the necessary research to see what the tax consequences of receiving unemployment benefits would be. I was more mad at myself than anything, but the reality was that, instead of getting a refund, I was going to be paying Uncle Sam a couple thousand dollars.

Tax news and advice

Here's how you can avoid having to do the same:

1. Get those taxes withheld

If you're currently unemployed, are receiving benefits and aren't having taxes withheld, request that they do so now. Yes, your benefit amount will decrease, but it's easier to cut back a little each week now than it is to come up with a larger lump sum when your taxes come due.

2. Review your filing options

If you received unemployment benefits in 2016 and didn't have taxes withheld, you're going to have to pay them. Fortunately, there are some ways to mitigate just how much.

"You do have to claim your unemployment income, but remember your new lower income may make you eligible for tax benefits you couldn't qualify for before," said Lisa Greene-Lewis, a CPA and tax expert with TurboTax. "You also may be eligible for tax deductions and credits which can lower your tax liability."

For example, you could qualify for the Earned Income Tax Credit, which is worth up to $6,269 for a family with three or more children. There's also the Child Tax Credit of $1,000 for each dependent under 17 years old, and Education Tax Credits like the Lifetime Learning Credit, which can be up to $2,000. (You can find a quick guide to common tax exemptions and deductions here.)

"Credits are great because they lower your tax liability dollar for dollar," Greene-Lewis said. "Also don't forget what the IRS calls above-the-line deductions like deductible expenses for educator expenses paid up to $250, student loan interest up to $2,500, moving expenses for a job, and deductible IRA contributions, which can lower your taxable income.

"If you make below the IRS income filing threshold of $10,350 single ($20,700 married filing jointly), you also may not be required to file your taxes, however, you should if you had federal taxes deducted in your paycheck," she said.

It could be worth your time and effort to get some guidance from a tax professional if you're feeling uncertain about how all these credits work. If you can't afford to pay a professional and you made less than $54,000 last year, there are free tax preparation services provided by the IRS. You may have to stand in line for a bit, but it could end up saving you significantly on your taxes.

3. Don't avoid filing or paying your taxes

Getting into trouble with the IRS is the last thing you want to deal with coming off of a stint of unemployment, so if you've reviewed all of the above options and find you're still going to have a hefty tax bill due that you simply can't afford, don't panic, and definitely don't put off dealing with the situation.

First, if you're once again employed and can qualify for a credit card with a 0% introductory offer for purchases, you could pay your tax bill using that card and pay it off over time without any interest or penalties. It's a good idea to check your credit scores before applying to ensure you qualify. You can get your two free credit scores, updated every 14 days, here on Credit.com.

If that's not an option for you, you could consider using a credit card you already have, especially if it has a low APR, but you'll end up paying significant interest, which will end up just costing you more money and probably isn't a great idea. Instead, your best bet is likely talking to the IRS and asking for an installment agreement. That, Greene-Lewis said, allows you to pay your tax liability over a six-year period if necessary.