Tax refunds offer way to pay debt, boost savings

Family

fundamentals

I'm anticipating a healthy tax refund this year. What's the best financial advice on what to do with it?

Last year, the Internal Revenue Service announced a week after the tax filing deadline that it had so far issued 84.7 million refunds averaging $2,144 per refund. Consumers often treat that money as a windfall rather than payment back on an individual-to-federal-government loan. But first things first: If you do get an income-tax refund, what will you do with it?

Financial planners have some standard guidance. The first thing most people should consider doing with any non-budgeted money is to pay off — or at least pay down on — any high-interest debt. For most people, that's credit card debt. If you have any outstanding balances on credit cards, first pay off the highest interest card, then work on the one with the next-to-highest interest. According to an annual survey by Myvesta, a nonprofit consumer education association, the average American carried $2,328 in credit card debt as of November 2005. If you get an average income tax return, and you have an average credit card debt, you should be nearly able to pay it off.

But let's say you're credit-debt free. You might consider putting that money toward other debt — a car loan, for example, or making extra principal payments on your mortgage.

Or, if your loan payments are manageable but you have little in savings, it might be a good idea to deposit the refund directly into a savings account. In a survey more than 1,000 women conducted by the Consumer Federation of America in November 2004, 42 percent of all women surveyed said they had emergency savings of less than $500. The group launched a campaign to encourage maintaining a minimum of $500 in savings, with a goal of building to $2,000 for emergencies. Common advice is to have three to six months of expenses in an emergency account.

If you feel comfortable with your emergency "get-my-hands-on-it-quickly" fund, take a look at Certificates of Deposit. Interest rates have been creeping up, and you could earn 4.5 percent or more if you're willing to keep your hands off that money for the time period specified (usually anywhere from six months to five years). Or, think even longer-term, and put your refund toward a 401K plan or a traditional or Roth individual retirement account (IRA).

Finally, it probably makes sense to take steps to prevent yourself from getting such a large return next year. After all, you could be putting that money in your own pocket paycheck after paycheck instead of loaning it to the government every year. Contact your employer's payroll office and file a new W-4 withholding form, decreasing the amount withheld from each pay. Then all you have to do is remember to use that extra money to reduce your debt and build your savings, all year long.

Family Fundamentals is a monthly column on family issues especially regarding finances and relationships. It is a service of Ohio State University Extension and the Ohio Agricultural Research and Development Center. Send questions to Family Fundamentals, c/o Martha Filipic, 2021 Coffey Road, Columbus, OH 43210-1044, or filipic.3@osu.edu.

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Dear Subscriber: Family Fundamentals is a monthly column on family issues. This column, the seventh in the series, was reviewed by Cäzilia Loibl, state finance specialist with Ohio State University Extension in the College of Human Ecology.

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