

# What to do with your income tax refund? Five ideas

For years I've been begging people not to use tax withholding as a forced savings tool.

I understand the reasoning. Times are tight and people want some financial security, even if it means letting the federal government keep their money out of fear they will waste it throughout the year.

But if you are going to continue being hardheaded just to get a tax refund, what should you do with it? For example, I received this question from a participant in a recent online discussion: "We're going to get a \$7,500-plus tax refund. I'm not sure how that's possible, but I triple-checked our return. Should we use the refund to pay down our mortgage?"

Rather than discuss once again why getting a refund is not a good idea unless it is prompted by a change in your tax situation

— birth of a child, marriage, home purchase — I want to talk about what to do with the money under certain circumstances.

**Situation One:** You have no emergency fund and lots of credit card debt.

In this case, set aside some of the refund and use the rest to pay off or pay down the credit card debt. Otherwise, if an unplanned expense arises, such as a car repair, you end up going further into debt.

**Situation Two:** You have some money put away for an emergency fund but not the recommended minimum of three months of living expenses. You have some credit card debt.

Let's say you've only managed to save about one month's worth of living expenses. You have \$2,000 in outstanding credit card debt. Your tax refund will be



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about \$2,000.

Don't worry about reaching the emergency fund target. You've got a good start. Pay off the credit card. With that debt gone, you can take the money you were paying for the debt (plus the interest) and continue building up your emergency fund.

**Situation Three:** You have an emergency fund equal to three months of living expenses. You have no credit card debt, but you have car and student loan debt. You're getting a tax refund of

\$5,000. The interest rate on your student loan is under 6 percent. But the remaining balance on your car loan is \$6,000 at 8 percent.

Pay down the car loan.

**Situation Four:** You have three months of living expenses saved. You have no credit card debt, no car loan. But you have \$10,000 in student loan debt. Your tax refund is \$4,000.

Reduce the student loan. But wait, you say, I could invest that money and earn more than the interest rate on my student loans. Or you might argue that it's OK to keep the debt because you get a tax deduction for some or all of the annual interest you pay.

Yes, in theory the math can work out and put you ahead if you invest the money from your return (minus taxes). But you haven't factored in risk and hu-

man nature. There is no guarantee that money invested will yield a return that would be substantially greater than the interest you pay on the loan. And I've found people who say they will invest the money but often don't.

**Situation Five:** You have more than enough in cash reserves and no other debt except a mortgage. That was the case with the reader who asked the question about a \$7,500 tax refund.

Before paying down the mortgage, consider two more things. If you have children, you might want to boost their college funds or start one. Also, review your retirement savings to determine if you are on track.

What I'm saying is if you're going to do a dumb thing and keep getting refunds unnecessarily, at least be smart about how you use the lump sum. □