What's the difference between a tax deduction and a tax credit?

Deductions reduce taxable income and their value thus depends on the taxpayer's marginal tax rate, which rises with income. Credits reduce taxes directly and do not depend on tax rates. However, the value of credits may depend on the taxpayer's basic tax liability. Nonrefundable credits can reduce tax to zero but any credit beyond that is lost.

OVERVIEW

An individual tax filer has the choice of claiming the standard deduction or itemizing deductible expenses from a list that includes state and local taxes paid, mortgage interest, and charitable contributions. In either case, taxable income is decreased by the amount of the allowed deduction.

The deduction reduces tax liability by the amount of the deduction times the filer's marginal tax rate, and is thus worth more to taxpayers in higher brackets. For example, a $10,000 deduction reduces taxes by $1,500 for people in the 15 percent tax bracket, whereas the same deduction cuts taxes by $3,500 for those in the 35 percent tax bracket.

IMPACT OF DEDUCTIONS

Determining the actual tax savings associated with deductions is, however, somewhat more complicated. High-income taxpayers have their itemized deductions reduced by the limitation on itemized deductions, called "Pease" after the Ohio congressman who proposed the provision. In 2015, Pease reduces itemized deductions by 3 percent of the amount by which adjusted gross income exceeds specified thresholds—$258,250 for single filers, $284,050 for heads of household, $309,900 for married couples filing jointly, and half of that for married couples filing separately. The limitation cannot reduce deductions by more than 80 percent, however.

The standard deduction and some itemized deductions are disallowed under the alternative minimum tax (AMT). For example, AMT taxpayers may not deduct state and local tax payments or items in the "miscellaneous" deductions category. The AMT reduces but does not eliminate other deductions.

Tax filers may claim some deductions in addition to the standard deduction or itemized deductions. These include deductions for contributions to individual retirement accounts, alimony payments, certain moving expenses, and interest on student loans. The personal exemption ($4,000 each for taxpayers and their

dependents in 2015) is also, in effect, a deduction because it reduces taxable income. The value of all of these deductions depends on the taxpayer's marginal tax rate and tax liability.

IMPACT OF CREDITS

Tax credits are subtracted not from taxable income, but directly from a person's tax liability; they therefore reduce taxes dollar for dollar. As a result, credits have the same value for everyone who can claim their full value.

NONREFUNDABLE CREDITS

Most tax credits are nonrefundable; that is, they cannot reduce a filer's tax liability below zero. As a result, low-income filers often cannot receive the full benefit of the credits for which they qualify. For example, the child and dependent care credit is nonrefundable, so a married couple with two children and income under $28,600 in 2015 cannot receive the credit because the family has no tax liability.

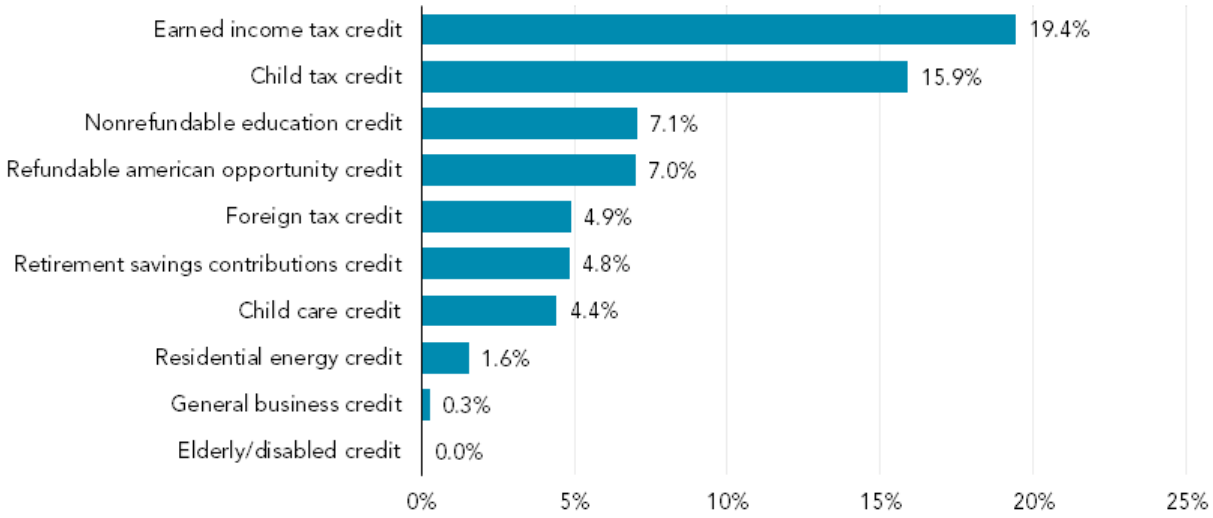
REFUNDABLE CREDITS

Some tax credits, however, are fully or partially refundable: if their value exceeds a person's tax liability, the excess is paid to the filer. The earned income tax credit (EITC) is fully refundable; the child tax credit (CTC) is refundable only if the filer's earnings exceed a $3,000 threshold. These two credits accounted for more than 52 percent of the dollar value of all credits claimed in 2012.

The EITC is the most commonly claimed credit, showing up on nearly 20 percent of 2012 tax returns. The CTC was nearly as popular, claimed on almost 16 percent of 2012 tax returns (figure 1).

FIGURE 1

Percentage of All Returns Claiming Selected Credits
2012

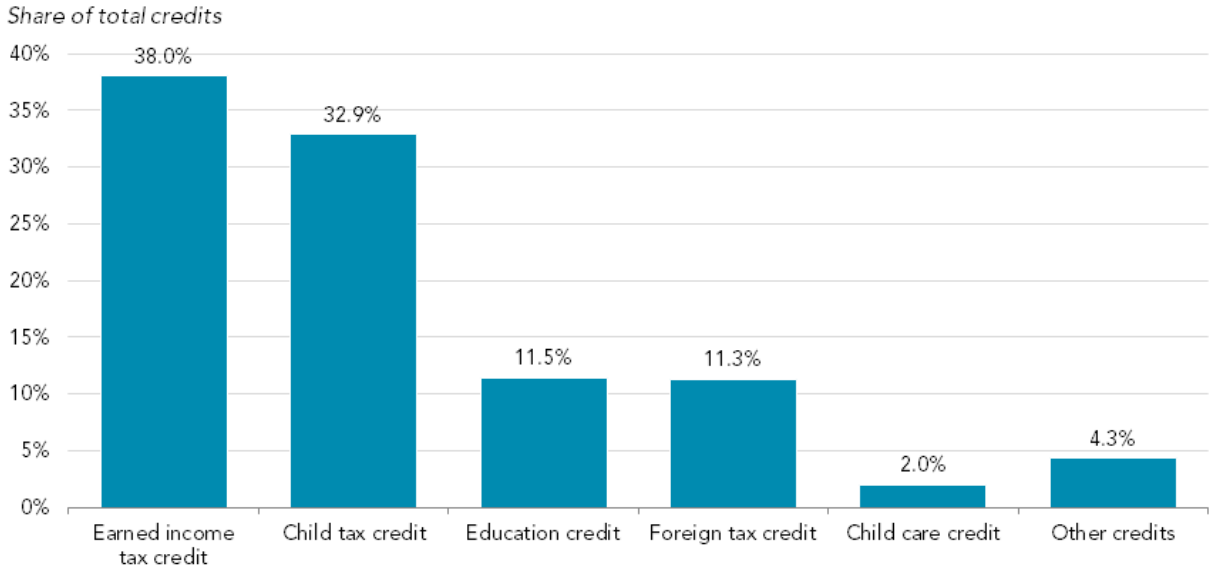


Source: Internal Revenue Service, Statistics of Income, Table A.
Note: .05% of all returns claim elderly/disabled credit.

The EITC is also the most costly tax credit, totaling about $64 billion in 2012, nearly 40 percent of the total for all tax credits. The child credit was the second largest at roughly $55 billion, another third of the total (figure 2).

FIGURE 2

Total Tax Credits by Type
2012



Source: Internal Revenue Service, Statistics of Income, Table A.

DATA SOURCES

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