Q. What are tax credits and how do they differ from tax deductions?

A. Credits reduce taxes directly and do not depend on tax rates. Deductions reduce taxable income; their value thus depends on the taxpayer's marginal tax rate, which rises with income.

TAX CREDITS

Tax credits are subtracted directly from a person's tax liability; they therefore reduce taxes dollar for dollar. Credits have the same value for everyone who can claim their full value.

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 income under $24,000 in 2018 would not be able to use the credit because they have no income tax liability.

Some tax credits, however, are fully or partially refundable: if their value exceeds income tax liability, the tax filer is paid the excess. The earned income tax credit (EITC) is fully refundable; the child tax credit (CTC) is refundable only if the filer's earnings exceed a $2,500 threshold. The refundable portion of the CTC is commonly called the Additional Child Tax Credit.

MOST POPULAR TAX CREDITS

The EITC is the most commonly claimed credit, showing up on more than 18 percent of 2016 tax returns. The CTC is nearly as popular, claimed on about 15 percent of 2016 tax returns (figure 1).

The EITC is also the costliest tax credit, totaling about $67 billion in 2016. The CTC (including the refundable portion) was the next largest at roughly $52 billion (figure 2).

TAX DEDUCTIONS

Tax filers have 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, filers decrease their taxable income by the amount of the allowed deduction.

Tax filers may claim some deductions in addition to the standard deduction or itemized deductions. These deductions (technically "adjustments to income") are sometimes called "above the line" deductions because they come before the line that determines adjusted gross income on tax return form 1040. Adjustments to income include contributions to individual retirement accounts, educator expenses, and interest on student loans.

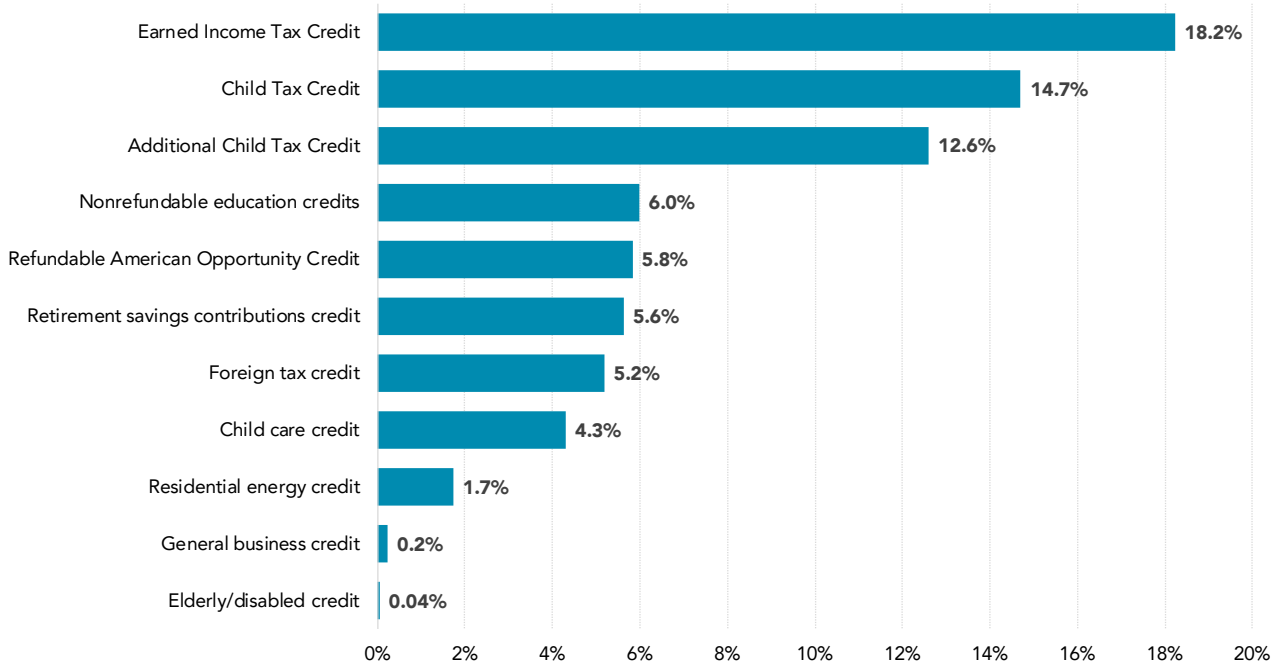
Key Elements of the U.S. Tax System

What are tax credits and how do they differ from tax deductions?

FIGURE 1

Total Returns Claiming Selected Credits

Share of all returns, tax year 2016

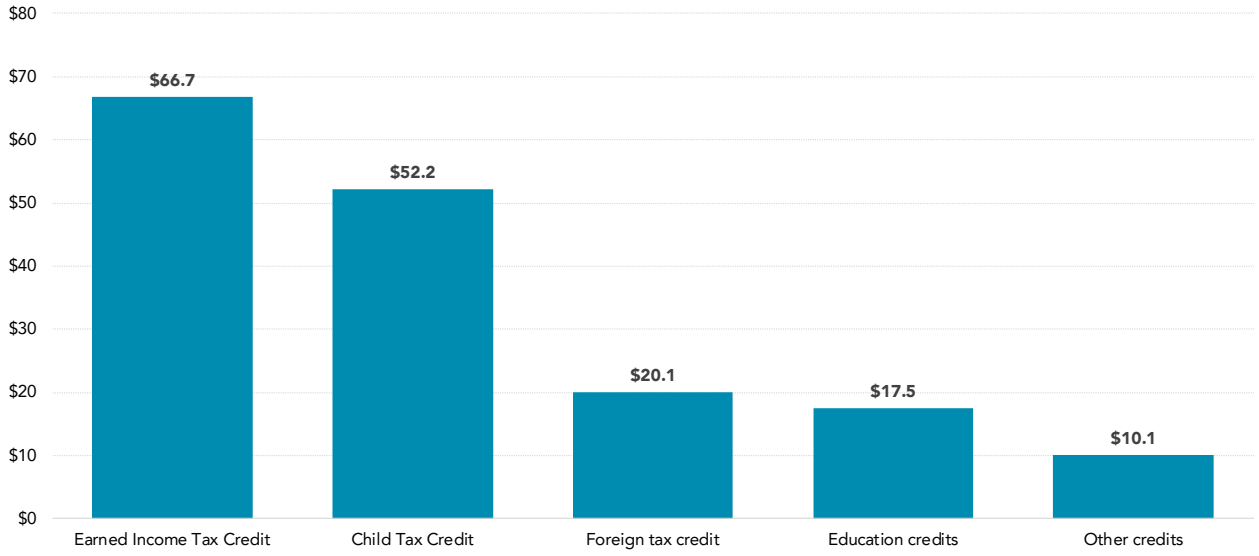


Source: Internal Revenue Service. Statistics of Income. Table A. "All Returns: Selected Income and Tax Items in Current and Constant Dollars," Tax Year 2016.

FIGURE 2

Total Amount Claimed for Selected Credits

Billions of dollars, tax year 2016



Source: Internal Revenue Service. Statistics of Income. Table A. "All Returns: Selected Income and Tax Items in Current and Constant Dollars," Tax Year 2016.
Note: "Child Tax Credit" = Child Tax Credit + Additional Child Tax Credit; "Education Credits" = Nonrefundable Education Credits + American Opportunity Credit; "Other Credits" = General Business Credit + Child Care Credit + Residential Energy Credit + Credit for the Elderly/Disabled.

Key Elements of the U.S. Tax System

What are tax credits and how do they differ from tax deductions?

The value of all deductions, itemized or otherwise, depends on the taxpayer's tax liability and marginal tax rate. A deduction cannot reduce taxable income below zero, so taxpayers lose the value of excess deductions once they reach that limit. Taxpayers can, however, carry over some unused deductions into future years. By reducing taxable income, a deduction lowers tax liability by the amount of the deduction times the taxpayer's marginal tax rate. Deductions are thus worth more to taxpayers in higher tax brackets. For example, a $10,000 deduction reduces taxes by $1,200 for people in the 12 percent tax bracket, but by $3,200 for those in the 32 percent tax bracket.

The alternative minimum tax (AMT) disallows the standard deduction and some itemized deductions. For example, AMT taxpayers may not deduct state and local tax payments. The AMT reduces but does not eliminate other deductions.

Data Sources

Internal Revenue Service. *Statistics of Income*. Table A. "All Returns: Selected Income and Tax Items in Current and Constant Dollars," Tax Year 2016; and *Basic Tables*: Tax Computation. Table 3.3. "All Returns: Tax Liability, Tax Credits and Tax Payments, by Size of Adjusted Gross Income," Tax Year 2016.

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Further Reading

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