

Why tax credits are better than tax deductions

This is an updated and additionally annotated with links [excerpt](#) from my book, "The Truth About Paying Fewer Taxes" (FT Press, 2009).

The Truth About Paying Fewer Taxes: Truth #9 – Why Credits Are Better

By [S. Kay Bell](#) | Feb 24, 2009

Taxpayers have gotten a lot smarter over the years.

Now folks know they usually can save more tax dollars by claiming tax credits. There are several reasons why credits tend to come out on top when you're looking for tax savings.

The main reason is that in tax parlance, "credit" means the same thing as it does when you see that line item on your charge account statement. A tax credit is a dollar-for-dollar benefit. The credit is applied to your final Internal Revenue Service bill, meaning you get money back or don't have to pay Uncle Sam as much.

A tax deduction, however, reduces the taxable income upon which your final tax bill is figured. Most deductions are claimed as [itemized expenses on Schedule A](#), but some are available directly on Forms 1040 and 1040A.

Regardless of where on the tax paperwork they are located, deductions share the same tax-saving goal: Less income by claiming deductions usually means a smaller tax bill.

But that's still generally not as much tax reduction as a credit provides.

You can get an idea of the value of credits by comparing the tax savings of an ostensibly larger deduction to that of a credit.

The tuition and fees [above-the-line deduction](#) offers eligible taxpayers a \$4,000 deduction from their gross income (at least through the 2016 tax year). Another tax break for educational expenses, the [Lifetime Learning credit](#), is only half that.

But don't be so fast to opt for the deduction.

With the \$4,000 [tuition and fees deduction](#), you subtract that amount from your earnings to get to your adjusted gross income and eventually reach a smaller taxable income amount. While there are several steps to get to your final taxable income level for illustrative comparison purposes, let's keep this simple: your earnings of \$50,000 then become \$46,000.

But that \$46,000 still leaves you in the 25 percent [tax bracket](#), meaning that your \$4,000 deduction is worth, when you finally compute your tax bill, only a fourth of its dollar value: \$4,000 x 25 percent, or \$1,000.

The \$2,000 Lifetime Learning credit, however, is subtracted from your final tax bill. So if you owed \$2,200 on your \$50,000 income, the credit will knock that down to only \$200.

Credit ebb and flow: In recent years, as lawmakers have looked to provide more breaks for constituent taxpayers, a number of credits have been added to the tax code. Congress sometimes adds them temporarily; other times, it [makes the tax breaks permanent](#).

But in each case, the guiding principle is the same. While deductions, whether itemized or the standard amount, help you whittle down the amount of income upon which your tax bill is figured, credits will cut your final IRS tab dollar-for-dollar, and in some cases even provide you a refund after you've zeroed out your bill.

Some popular core credits have stood the test of time and taxpayers. These include credits to give you a break for caring for, or simply having, children, saving for retirement, furthering your or a family member's education, and even recouping Social Security overpayments.

Refundable versus nonrefundable: Although credits generally are preferable to deductions, some credits have greater tax appeal than others.

There are two types of tax credits: refundable and nonrefundable. Again, this is a case where the IRS actually means what it says.

A refundable credit means that the tax break will get you money back from the IRS even if your tax bill is zero. For example, you owe \$500 and can claim a \$1,000 tax credit. If that credit is refundable, you'll get \$500 back as a refund.

However, if the credit is nonrefundable, you'll only be able to use the credit to zero out your tax bill, but no more than that. The excess \$500 from the credit is lost.

As you have likely surmised, most tax credits are nonrefundable. The major, and most popular, credits in this category are the following:

- Child Tax credit, which can be claimed by parents of young children.
- Child and Dependent Care credit, available to working parents.
- Credit for the Elderly or Disabled, which provides tax savings to folks age 65 or older or to disabled taxpayers of any age.
- Retirement Savings Contributions credit, which encourages individuals to build their nest eggs.
- Adoption credit, offering additional tax help when you add to your family.
- [American Opportunity Tax Credit](#) (which replaced the Hope credit) and Lifetime Learning credits, to help taxpayers and their families further their educations.

Only four permanent credits offer you the chance at a refund, as follows:

- Earned Income Tax Credit, created for lower-income workers.
- Additional Child Tax Credit, which some taxpayers can file for after claiming the basic Child Tax credit.
- American Opportunity Tax Credit, a portion of which is refundable for some taxpayers
- Credit for taxes withheld on wages and other amounts, which helps employees recover Social Security withholding amounts that exceeded the statutory limit.

These are just a few of the more popular tax credits. Every year, federal lawmakers find room in the tax code for a few more credits. These usually are limited to very specific situations, such as the purchase of an alternative-fuel vehicle, and tend to be temporary.

But it's worth the time and effort to take a look at your tax form – the long Form 1040 gives you the most complete picture of available tax breaks – to see if a credit might help reduce

your tax bill.

Tax credit limits: While claiming credits generally is the wiser tax move, even they have their limits.

Many credits are reduced or even unavailable for taxpayers who earn over certain income thresholds. Some of these limits are set by statute; others are adjusted periodically for inflation.

In many cases, age and filing status also are a factor in a taxpayer's ability to claim a credit.

Because the IRS frowns on double-dipping, you must be careful to coordinate your tax credit claims with other possible tax benefits.

If you believe a tax credit could be useful, be sure to double-check its eligibility parameters. In some cases, such as with the Earned Income Tax Credit, the IRS web site (www.irs.gov) offers interactive programs to help you determine your tax-break eligibility.

One final note about credits. Although you tend to see them paired off against deductions when the value of each is discussed, the use of these tax breaks is not an either/or situation.

You can claim every available tax deduction for which you qualify and also utilize as many tax credits for which you're eligible. The combination of the two is a great way to get your tax bill to its lowest possible level.