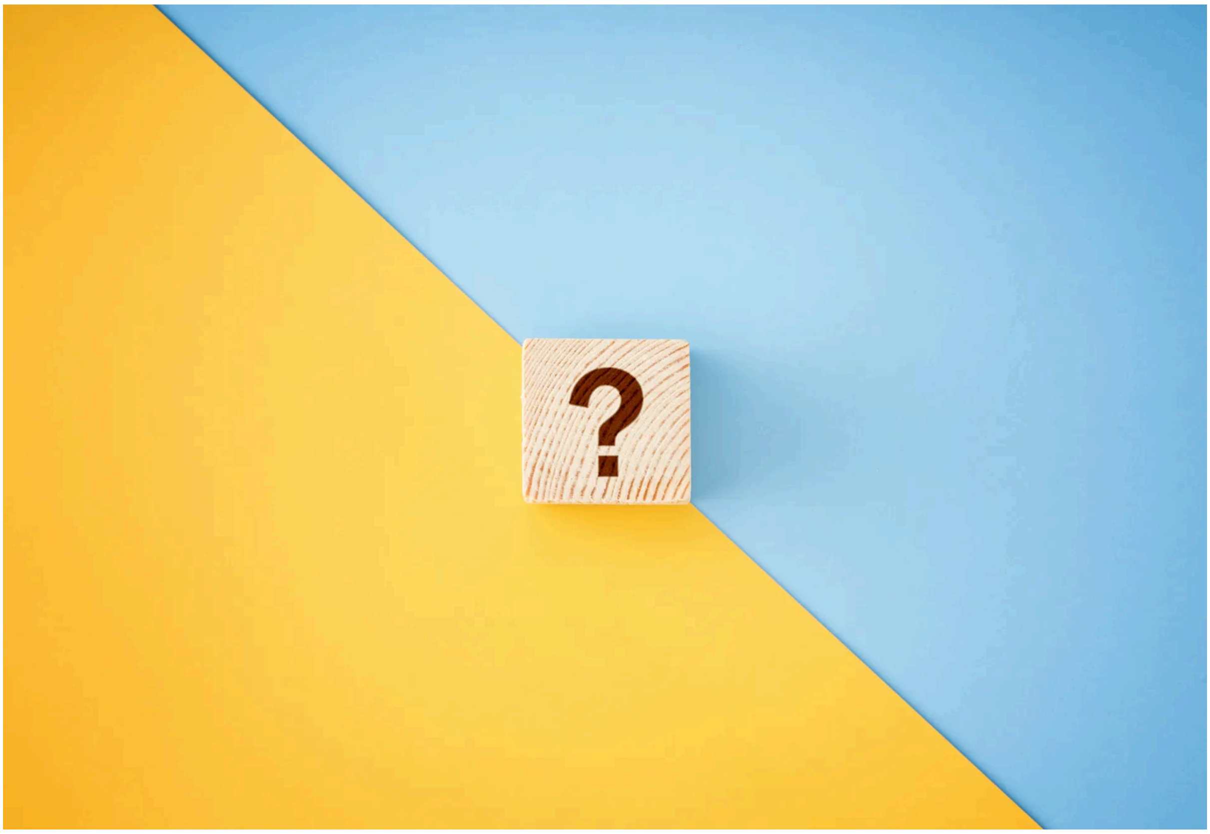
TAXES

Tax Credit vs. Tax Deduction: What's the Difference?

Your guide to tax deductions and credits, how the IRS treats them differently, and how they impact your tax bill.



Whether you're filing for the first time or have been around the tax return block, it's easy to confuse tax credits and deductions.

Although both can help lower your tax bill, the IRS describes a tax credit as a "dollar-for-dollar" reduction of your income, while a tax deduction reduces your taxable income.

Here's more of what you need to know about the key differences between credits and deductions.

What is a tax credit vs. a tax deduction?

First, let's go over the similarities between tax credits and deductions.

Both:

- Have eligibility requirements
- Can be state or federal

However, a tax deduction only lowers taxable income (the amount of your earnings that is subject to taxes). A tax credit directly lowers the tax that you owe.

This difference means:
- A tax credit lowers your tax bill directly, while
- A tax deduction depends on factors like your federal income tax bracket.

The easiest way to see how this difference impacts your taxes is through an example, which we'll go through next.

How to calculate a tax deduction and a tax credit

Assume an adjusted gross income (AGI) of $55,000 and a tax credit vs. a tax deduction of $5,000.

	Tax Deduction	Tax Credit
AGI	$55,000	$55,000
Tax Deduction	**-$5,000**	
Taxable Income	$50,000	$55,000
Tax Rate*	22%	22%
Tax Calculated	$11,000	$12,100
Tax Credit		**-$5,000**
Taxes Owed	$11,000	$7,100

**The example is based on a single filer using 2024 Income Tax Brackets and Rates.*

As you can see, in this simplified example, the tax credit reduces taxes owed more than the tax deduction does.

However, real-life situations are often more complex and may have limitations that may limit how much tax relief you can claim.

Refundable and non-refundable tax credits

The benefits of your tax credit may be curbed by whether the credit you're claiming is refundable or non-refundable.

- A refundable tax credit means you may be eligible for a tax refund.
- Non-refundable tax credit does not lead to a tax refund, even if you qualify for the maximum amount.

There can be income limits and other eligibility rules for each type of tax credit. Additionally, some tax credits are partially refundable.

Perhaps the most well-known is the Child Tax Credit (CTC). While offered at the federal and state levels, the federal CTC has a refundable portion adjusted for inflation.

Tax credit examples

If you are looking to claim a tax credit, there are several common examples for which you may be eligible, including:

- Earned Income Tax Credit (EITC) is a refundable credit for those with low-to-moderate income, including those without qualifying children.
- Child Tax Credit (CTC) provides a tax credit of $2,000 per child under age 17. As mentioned, the refundable portion of the credit is $1,700.
- Electric Vehicle (EV) Tax Credit is a nonrefundable credit of up to $7,500 on the purchase of new qualified EVs. (Income and price limits apply.)

There are also federal tax credits for homeowners, education tax credits, and tax credits for efficient home improvement.

Above-the-line deduction examples

When people hear "tax deduction" they probably think about whether to itemize or take the standard deduction. Most people claim the standard deduction, especially since the Tax Cuts and Jobs Act (TCJA) nearly doubled the base amount.

But there’s another type of deduction that may be helpful since you don’t have to itemize to benefit.

These deductions are called “above-the-line” because they’re deducted from your gross income when arriving at your AGI.

Examples of above-line tax deductions include:

- Contributions to an IRA or Health Savings Account (HSA)
- Educator expense deduction
- Student loan interest tax deduction

Note: deductions, like credits, can be limited based on age, income, filing status, or adjusted for inflation. Be sure you meet eligibility requirements before claiming either.

Next, we’ll cover the more widely heard “below-the-line” deductions — itemized vs. standard.

Examples of itemized deductions (below the line)

Below-the-line tax deductions are claimed after AGI (as with our earlier example). They come in two different flavors:

- The standard deduction. Available to all taxpayers, or
- The itemized deduction. Available to those who keep track of many qualifying expenses throughout the tax year.

You’ll want to take the larger of your itemized amount or your standard deduction amount. You cannot claim both.

Here are a few common itemized deductions you may consider in your calculation:

- Charitable contributions
- Property tax
- Mortgage interest
- Gambling losses
- Medical expenses
- Both tax credits and deductions can provide potential tax savings, and it’s important to know which ones you can claim.

Consult with a tax professional to find the best options for your tax situation.

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