

Tax Deduction vs. Tax Credit

Tax Deduction

A tax deduction reduces income subject to tax.

For each dollar of tax deduction, the reduction in tax liability is less than a dollar.

Assume that the tax rate is 15 percent and the tax deduction is \$200.

The Effect of Deductions on Income Subject to Tax		
	Without Deduction	With Deduction
Income Subject to Tax	\$10,000	\$9,800
Tax at 15%	\$1,500	\$1,470

At a 15 percent tax rate, a \$200 **tax deduction** results in a \$30 reduction in the tax.

Tax Credit

A tax credit is a dollar-for-dollar reduction in the tax liability.

For each dollar of tax credit, there is a dollar reduction in the tax liability.

Continuing with the example, assume that the tax credit is \$200.

The Effect of Deductions and Credits on Income Subject to Tax		
	Without Deduction With Credit	With Deduction Without Credit
Tax	\$1,500	\$1,470
Tax Credit	-(200)	0
Total Tax	\$1,300	\$1,470

A \$200 **tax credit** results in a \$200 reduction in the tax liability. This is a dollar-for-dollar reduction in the tax liability.

With a \$200 **tax deduction**, the total tax is \$1,470.

With a \$200 **tax credit**, the total tax is \$1,300.

The taxpayer pays less tax with a \$200 tax credit than with a \$200 tax deduction.

http://www.irs.gov/app/understandingTaxes/howstax_tutorials/mod09/tt_mod09_02.jsp