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Is It Better to Have a Tax Credit or a Deduction?

Article Highlights:

- Itemized Deductions
- Above-the-Line Deductions
- Business Deductions
- Asset-Sale Deductions
- Refundable Credits
- Nonrefundable Credits
- Carryover Credits
- Business Tax Credits

People often say that an expense is “a tax write-off”; most everyone interprets this to mean that the expense will have a tax benefit. Generally, such a benefit takes the form of either a deduction or a credit; these benefits’ effects are quite different, however, and each type has various categories. As a result, the tax implications may not be as expected. This is especially true when the write-off claim comes from a salesperson who is touting the tax benefits of a product or service, as such individuals often leave out key details. In general, a deduction reduces taxable income, whereas a credit reduces the tax itself.

Tax Deductions – In one way or another, tax deductions reduce the taxable portion of an individual’s income, which thus reduces the tax on that income.

Itemized Deductions – When taxpayers think of deductions, they typically think of the itemized deductions that are claimed on Schedule A. This is the only way to deduct personal expenses such as medical costs, state and local tax payments, investment and home-mortgage interest, charitable contributions, disaster-casualty losses, and various rarely encountered expenses. In some cases, itemized deductions are limited. For instance, medical expenses are only deductible to the extent they exceed 10% of the taxpayer’s adjusted gross income (AGI). Similarly, state and local tax payments (including those for income, sales, and property taxes) are capped at $10,000. On top of that, itemization only reduces taxable income to the extent that the total of the itemized deductions exceeds the standard deduction. When the sum does not exceed the standard deduction, the itemized deductible expenses provide no tax benefits at all.

Above-the-Line Deductions – Certain deductions actually reduce income. These are commonly called above-the-line deductions because, when applied, they reduce the income figure that is used to calculate AGI. Thus, their benefits apply regardless of whether the taxpayer uses itemized deductions. Above-the-line deductions include educators’ expenses; contributions to health savings accounts, traditional IRAs, and certain qualified retirement plans; deductible alimony payments; and student-loan interest. Most of these deductions have annual maximums.

Business Deductions – Taxpayers who operate noncorporate businesses can deduct from their business income any expenses that they incur when operating their businesses. These deductions (which cover advertising fees, employee wages, office-supply costs, etc.) are used to reduce profits, which in turn reduces taxable income and, ultimately, income tax. In addition, most self-employed taxpayers pay Social Security and Medicare taxes on their net business income, so any reduction in their business profits also reduces their Medicare taxes and possibly their Social Security taxes.

Asset-Sale Deductions – An individual who sells an asset is allowed to deduct that asset's cost from the sale price to determine the taxable profit. Good record keeping is helpful here because the original expense may have been incurred years prior, even though it is only deductible when the asset is sold. For example, any improvements that an individual makes to a home over years of ownership are not deductible until the home is sold. At that point, the individual can reduce the taxable gain from the sale by counting the improvements as part of the home's cost.

Tax Credits – Tax credits come in several varieties, and the amount of benefit can vary:

Refundable Credits – A refundable credit offsets current tax liability; it is so called because any amount of unused credit is refunded to the taxpayer. Refundable credits include the Earned Income Tax Credit, the Additional Child Tax Credit, and the Premium Tax Credit (net of any advances received), as well as the American Opportunity Tax Credit (an education credit that is 40% refundable). As a matter of general interest, these credits are subject to significant filing fraud because of their refundability. The IRS also considers prepayments such as income-tax withholding and estimated tax payments to be refundable credits.

Nonrefundable Credits – A nonrefundable credit only offsets tax liability; any unused amount is lost (unless it can be carried over to another year; see below). Over time, Congress has become more generous with credits; most credits that are not refundable now carry over for a given period. Nonrefundable credits include the Saver's Credit, the Lifetime Learning Credit, and the personal portion of the Electric Vehicle Credit.

Carryover Credits – For some nonrefundable credits, any unused current-year credit can be carried over to the next tax year (or for a longer period) until the carryover amount is used up. These credits include the Adoption Credit (which can carry over for up to five years) and the Home-Solar Credit (which carries over through at least 2021; tax law is unclear on whether it will expire then).

Business-Tax Credits – Numerous business-tax credits are available; however, they are grouped into the General Business-Tax Credit, which is nonrefundable but which carries forward for twenty years and back for one year. (This allows a business owner to amend the prior year's return so as to claim the credit.) This category includes the business portion of the Electric Vehicle Credit.

If you have questions related to how you might benefit from tax credits or deductions, please call this office.

3 Common Personal Income Tax Problems & How to Respond

Tax problems aren't just a worry that hang over people's heads from January through April every year. Many of them go far beyond the numbers that you report, and they can require additional evidence that your bank statements and paychecks can't provide. Additionally, the IRS isn't the only source of those problems: state tax authorities are hungry for revenue, and if you divide your time among different states, you may find it difficult to establish nexus and may even have to file taxes in multiple states.

Below are some of the most common personal income tax issues people are likely to face.

1. You didn't make (or underpaid) estimated tax payments on self-employment income.

Self-employment is the most common cause of this. When you're used to having taxes withheld from your paychecks at work, it can be a shock to have to pay taxes yourself. You can end up owing not just a large amount of self-employment and income taxes, but also penalties for not making tax payments on time. Estimates must be deposited quarterly, or you will face an underpayment penalty.

If your total tax due when you go to file is under $1,000, you won't have to worry about getting smacked with an underpayment penalty. However, it's a good idea to set aside at least 30%-35% of your income for estimated tax payments and commit to paying this amount every month if quarterly taxes are too complicated to figure out.

Other situations like freelancing on the side or rental income while you're still employed can also cause you to fall short at tax time, so make sure to have extra taxes withheld from your paycheck if you don't want to make estimated payments. State tax payments also shouldn't be neglected.

2. You didn't correctly file state tax returns after moving.

Moving to a state with little or no income taxes like Nevada or Florida can be appealing if your bank account feels squeezed in high-tax states like New York or California. Many people divide their time between multiple states for work or personal reasons, and if it's not just a two- or three-week creative retreat or corporate assignment, it can make nexus difficult to determine in some cases.

With the prospect of a lower tax burden becoming even more appealing, it seems logical to just move to the tax-haven state you've been eyeing. But even after you file for a change of address with the postal service, change your voter registration, and get recognized as a resident by your new state, the high-tax state that you left is likely to also still treat you as one.

Typically, you must spend at least 183 days of the year in the other state and maintain a primary residence there. Simply having property in another state won't do if the rest of your family doesn't also live and wait there for you after your work or travel. Where you spend time outside of work also matters because where you sleep every night is ultimately what counts.

If your move is indeed permanent and your residency is valid, you may have to file a part-year resident tax return for the final months you stayed in the old state. You won't need to worry about it for following years, but keep track of how many days were spent in each state before and after moving day.

3. You neglected to file state income tax returns as a nonresident.

If you have business or rental income in another state, you may be required to file state tax returns as a nonresident. If this income is significant, it can end up producing a large tax bill if you're unprepared.

If you have an out-of-state job, chances are that your payroll provider may also be incorrectly withholding taxes for the appropriate state and/or city. In concentrated regions like the tri-state area, especially for New York City and Philadelphia residents, ensure that city taxes are being correctly withheld if you are a resident, and that withholding curtails if that is no the longer the case. There are usually reciprocity agreements among states and municipalities in areas where state lines cross, but you should carefully check to make sure you don't owe nonresident taxes in addition to what you owe your home state.

Failure to make tax payments on time, and to the right agency, are income tax problems that are often overlooked and can quickly spiral out of control. To avoid these issues and many more, contact our office so we can consult you on your state and local taxation, as well as rules for establishing nexus.

Thank you for selecting our firm for your tax and accounting needs. We appreciate the confidence you have shown in us, and we remain ready to assist you at any time.

Scott Jensen
Kramer & Jensen, LLC

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