

Tax Exemptions, Deductions, and Credits

Tax exemptions, deductions, and credits all can reduce the amount of taxes that a person owes. Some of these tax benefits are intended to reflect a person's ability to pay tax; the Child Tax Credit, for example, recognizes the costs of raising children. Other tax benefits, such as the deductions for charitable donations and home mortgage interest payments, are incentives intended to advance specific social policy goals.

Exemptions and Deductions

Exemptions and deductions indirectly reduce the amount of taxes a filer owes by reducing his or her "taxable income," which is the amount of income on which a filer pays taxes. (For more information on taxable income, refer to "[Policy Basics: Marginal and Average Tax Rates](#).")

For example, a \$100 exemption or deduction reduces a filer's taxable income by \$100. It reduces the filer's taxes by a maximum of \$100 multiplied by the tax rate the filer would have faced on that \$100 in income. Since current income tax rates range from 0 percent to 37 percent, a \$100 exemption or deduction reduces a filer's taxes by between \$0 and \$37.

Certain types of income, such as portions of retirement income and some academic scholarships, are **tax exempt**, meaning that they are not included as part of a filer's taxable income. Before 2018, filers could also claim a **personal exemption**, which was an amount that each filer could exclude from his or her taxable income; the exemption was \$4,050 in tax year 2017. Filers could also claim exemptions for a spouse and each dependent. Beginning in 2018, the new tax law eliminates personal exemptions until 2026.

Policy Basics – Tax Exemptions, Deductions, and Credits

A **tax deduction** is a specific expense that a taxpayer has incurred and can subtract from their taxable income. Deductions therefore can encourage certain uses of income.

- All filers are eligible to claim a **standard deduction**, which was significantly raised to \$24,000 for married filers in 2018. The standard deduction is adjusted for inflation annually, and it is \$24,800 for married filers in 2020. Filers may instead claim **itemized deductions** for certain expenses such as home mortgage interest, charitable contributions, and state and local taxes. Most filers take the standard deduction. Higher-income filers are much more likely to itemize because the amount they spend on qualifying deductions is typically greater than the standard deduction.
- Taxpayers can claim certain deductions, called **above-the-line deductions**, whether they take the itemized deduction or the standard deduction. Examples include the deductions for interest paid on student loans and contributions to individual retirement accounts (IRAs).

Tax deductions (and exemptions) are worth different amounts to different taxpayers because, as discussed above, their value is tied to a taxpayer's marginal tax rate. For example, high-income taxpayers in the 37 percent bracket receive a subsidy of 37 cents for every dollar of additional mortgage interest payments they deduct, while middle-income taxpayers in the 12 percent bracket get an interest subsidy worth only 12 cents on the dollar. Higher-income filers receive the greatest tax benefit from deductions because they face the highest tax rates.

In addition, for many low-income filers, the total amount of their deductions equals or exceeds their income, which means they have no taxable income. In such cases, they receive no tax benefit from any additional deductions.

Credits

In contrast to exemptions and deductions, which reduce a filer's taxable income, credits *directly* reduce a filer's tax liability – that is, the amount of tax a filer owes. Taxpayers subtract their credits from the tax they would otherwise owe to determine their final tax liability. That means that a \$100 tax credit reduces the amount of tax a filer owes by a maximum of \$100.

Some tax credits are **refundable**, meaning that filers whose credit amount exceeds their tax liability can receive the difference in the form of a full or partial cash refund. Refundable tax credits thus have the same value for all tax filers, regardless of their income. The Earned Income Tax Credit, for example, is a refundable credit designed to encourage and reward work as well as offset federal payroll and income taxes.

Non-refundable credits, in contrast, are worth less to many lower-income filers than to other filers. For example, a filer who qualifies for a \$2,000 non-refundable credit but has a tax liability of only \$1,000 can use half of the credit to eliminate their tax liability but must forfeit the other half.

Even refundable credits do not reach everyone, since only households with earnings from work can qualify. Still, making credits refundable extends their reach to many low-income households. This is important

Policy Basics – Tax Exemptions, Deductions, and Credits

because the social policy objectives of many tax incentives — such as encouraging people to save for college or retirement — are often particularly relevant to low-income households.

Comparing the Value of Deductions and Credits

The table below compares the value of deductions, non-refundable credits, and refundable credits for three tax filers: Filer A has no taxable income, Filer B is in the lowest marginal tax bracket (10 percent), and Filer C is in the highest bracket (37 percent). In the example below, all filers are married.

TABLE 1

Value of Deductions, Non-Refundable Credits, and Refundable Credits

Tax Filer	Top Marginal Tax Bracket	Taxable Income Range ^a	Value of \$2,000 Deduction	Value of \$2,000 Non-Refundable Credit	Value of \$2,000 Refundable Credit
A	0% ^b	\$0	\$0	\$0	\$2,000
B	10%	\$1 to \$19,750	Up to \$200 (\$2,000 x 10%)	Up to \$1,975 (\$19,750 x 10%) ^c	\$2,000
C	37%	\$622,051 or more	Up to \$200 (\$2,000 x 10%) ^d	\$2,000 ^e	\$2,000

^a To calculate taxable income, a tax filer subtracts from their total income the standard deduction (\$24,800 for married couples, \$12,400 for single filers, and \$18,650 for heads of households) or the value of their itemized deductions, as well as any above-the-line deductions. Tax liability is then calculated based on a filer's taxable income.

^b A tax filer is in the 0% bracket when their taxable income is \$0. For instance, Filer A may have up to \$24,800 of total income (for a married couple), which is then reduced to \$0 by the standard deduction. Even though Filer A has no taxable income, they must have earned income to qualify for the refundable credit.

^c The first \$19,750 of taxable income is subject to the 10 percent rate. In this example, Filer B has taxable income between \$1 and \$19,750.

^d The maximum value of the deduction is \$740 since the largest marginal tax bracket is 37% ($\$2,000 \times 37\% = \740).

^e Assuming a positive tax liability of at least \$2,000.

The \$2,000 deduction provides no benefit to Filer A because Filer A has no taxable income. Filer B receives up to \$200 in tax benefits from the deduction, and Filer C receives up to \$740.

Similarly, the \$2,000 non-refundable credit delivers no tax benefit to Filer A because Filer A has no tax liability. The credit is worth up to \$1,975 for Filer B since the credit is worth \$2,000 or the amount of Filer B's tax liability without the credit, whichever is lower. Filer C, a high-income filer in the top tax bracket, is assumed to have at least \$2,000 in tax liability without the credit and therefore can benefit from the credit's full \$2,000 value.

Policy Basics – Tax Exemptions, Deductions, and Credits

The \$2,000 refundable credit, in contrast, is worth \$2,000 to all three filers. Filer A, who has no tax liability, would receive the entire amount as a refund from the IRS (assuming that they had earnings from work of at least \$2,000).

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For more information on tax exemptions, deductions, and credits, see:

Marginal and Average Tax Rates

<https://www.cbpp.org/research/policy-basics-marginal-and-average-tax-rates>

Where Do Our Federal Tax Dollars Go?

<https://www.cbpp.org/research/federal-budget/policy-basics-where-do-our-federal-tax-dollars-go>

The Earned Income Tax Credit

<https://www.cbpp.org/research/federal-tax/policy-basics-the-earned-income-tax-credit>

The Child Tax Credit

<https://www.cbpp.org/research/federal-tax/policy-basics-the-child-tax-credit>