INCOME, CREDITS, AND DEDUCTIONS

Powerful Ideas: Personal Tax Deductions and Credits

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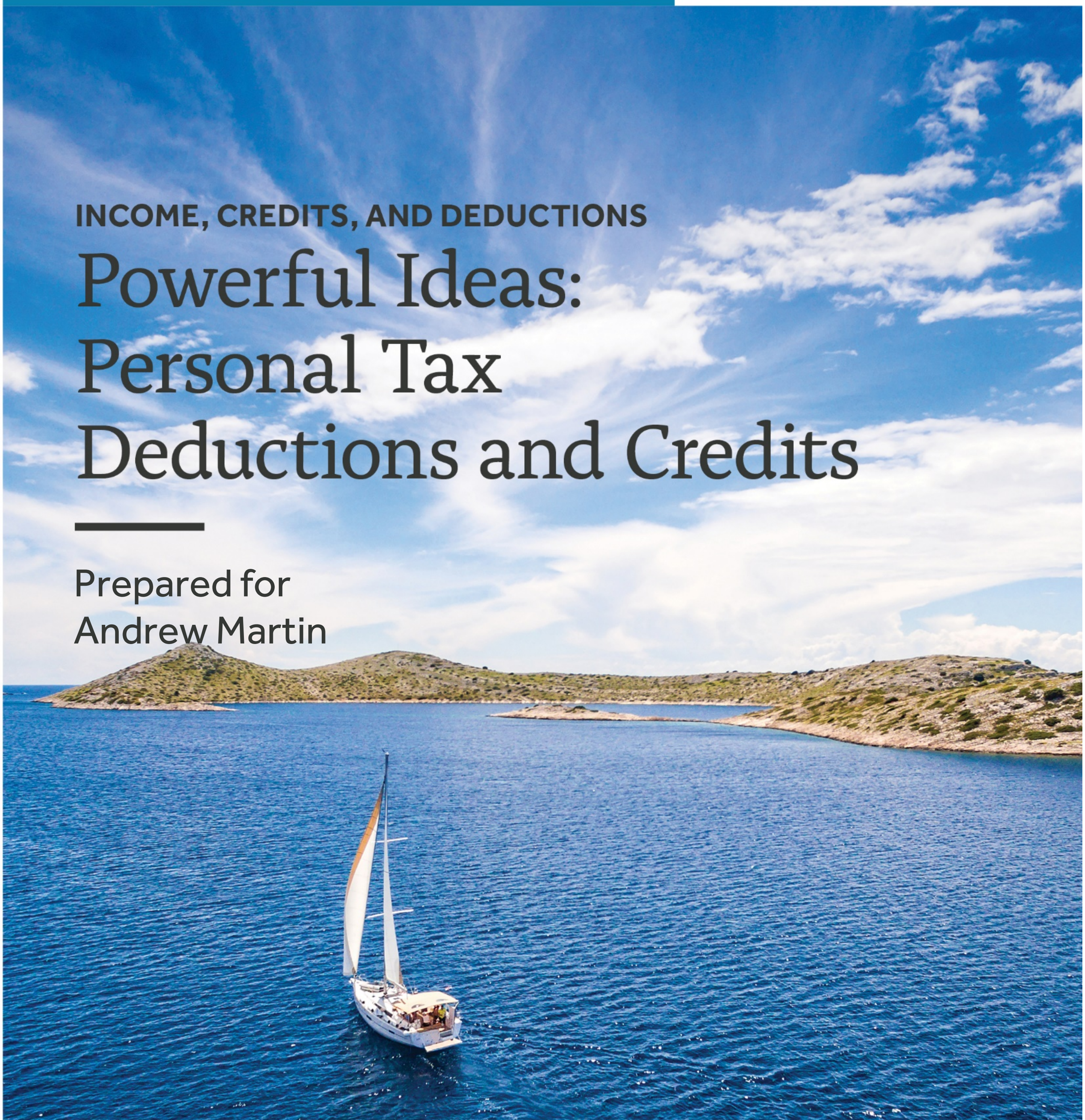

Personal Tax Deductions and Credits

Income Tax Deductions and Income Tax Credits – In General

An income tax deduction is a reduction in the amount of income a taxpayer is required to pay tax on. Deductions are subtracted from taxable income, reducing the amount of income subject to tax, thereby reducing the amount of a taxpayer's liability. For example, if a taxpayer has a marginal tax rate of 24%, for every dollar of deductions, he/she will save 24 cents of taxes.

A tax credit is an amount of money that a taxpayer is able to subtract from a tax liability owed to the government, i.e. a tax liability is calculated based on the taxpayer's income and deductions, and credits are used to reduce the amount of tax liability owed. For example, if, after adding up all income and deductions, a taxpayer owes a tax liability of $10,000, and has tax credits of $5,000, he/she will pay taxes of only $5,000.

What Income Tax Deductions are Available for Individuals?

There are two primary classifications for deductions: "above the line" deductions and "below the line" deductions. Above the line deductions (or adjustments to income) are reported on page 1 of a taxpayer's individual tax return and are used to calculate a taxpayer's adjusted gross income (AGI). Below the line deductions modify the taxpayer's AGI in order to calculate his/her taxable income.

Non-Business Related above the Line Deductions Include the Following:

- **Student Loan Interest Deduction:** The student loan interest deduction allows taxpayers to deduct the interest paid on qualified student loans during a tax year. Taxpayers can deduct up to $2,500. Qualified student loans are loans taken out solely to pay for qualified education expenses for a qualified student. Taxpayers receive the full deduction if their AGI is under $70,000 (for single taxpayers) and $140,000 (for married filing jointly). The deduction is phased out if income is between $70,000 and $85,000 ($140,000 and $170,000 for married filing jointly) and cannot be claimed if income exceeds $85,000 (or $170,000 for married filing jointly).

- **Contributions to Health Savings Accounts (HSAs):** Contributions made to HSAs are tax-deductible and enable a person to save pre-tax dollars for future healthcare expenses. For 2020, contributions to HSAs are limited to $3,550 for individuals and $7,100 for families. Individuals 55 and older are able to make an additional $1,000 contribution.

- **Deduction for Contributions to IRAs:** Contributions to IRAs may be deductible, up to $6,000 (in 2020). Individuals 50 and older are able to make an additional $1,000 of deductible catch-up contributions. Deductibility depends on income levels and whether the taxpayer or his/her spouse is covered by an employer retirement plan.

Taxpayers have the choice to either itemize their below the line deductions or take the standardized deduction. If a taxpayer itemizes deductions, he/she CANNOT take the standard deduction. The standard deduction is a fixed dollar amount provided by statute that allows a taxpayer to reduce the amount of income on which they are taxed. The standard deduction varies by filing status. For the 2020 tax year, taxpayers who file as single receive a $12,400 deduction, taxpayers who file Married Filing Jointly and Qualifying Surviving Spouses receive a $24,800 deduction, taxpayers who file Head of Household receive an $18,650 deduction, and taxpayers who file Married Filing Separately receive a $12,400 deduction.

A Non-Exhaustive List of Itemizable Deductions Includes the Following:

- **The Mortgage Interest Deduction:** Taxpayers who own a home are able to deduct the mortgage interest paid on the first $750,000 of new acquisition debt. This amount was reduced from $1 million in 2017. This lower debt limitation only applies to new mortgages taken out after December 15th of 2017; any existing mortgages retain their deductibility of interest on the first $1 million. In addition, a refinance of a "grandfathered" mortgage retains the $1 million debt limit (but only to the extent of the then-remaining debt balance, and not any additional debt). The $750,000 debt limit is a total debt limit for the taxpayer, meaning that the $750,000 debt limit applies to both primary and designated secondary home indebtedness. On the other hand, interest from a home equity line of credit is no longer deductible beginning in 2018, unless the equity line is used to buy, build or substantially improve the taxpayer's home that secures the loan.

- **Deduction for State and Local Taxes:** Taxpayers receive a deduction for amounts paid for (1) property taxes, (2) state and local income and sales taxes and (3) a combination of the first two, however, the deduction is limited to $10,000 per year.
- **Charitable Deductions:** A deduction is available for contributions made to certain non-profit organizations. The deduction can between 30% and 60% of AGI depending on what type of property is contributed and what type of organization the contribution is made to.

What Income Tax Credits are Available for Individuals?

The following is a non-exhaustive list of some of the most commonly used tax credits available for individual taxpayers in 2020:

- **Child Tax Credit:** The Child Tax Credit (CTC) is designed to help families with dependents by offering money back on their taxes for each qualifying child in the household under age 17. The child tax credit is a $2,000 credit per qualified child that phases out when taxpayers have income in excess of $200,000 (for single filers) or $400,000 (for married couples filing jointly).
- **American Opportunity Credit:** The American Opportunity Credit is a credit of up to $2,500 for education expenses paid per eligible student. It is only available for four tax years per student and is only available if the student has not completed the first four years of postsecondary education before the end of the tax year. Eligible students must be enrolled at least half-time for at least one academic period and must be pursuing a program leading to a degree or other recognized credential. The expenses that count toward the credit are limited and include only tuition payments, required fees, and course materials. Ancillary items like room and board or transportation costs do not qualify. If a taxpayer's Modified Adjusted Gross Income (MAGI) is above $90,000 for single filers or $180,000 for joint filers, then he/she can't claim the American Opportunity Credit. Only partial credits are available for those with MAGI above $80,000 and $160,000, respectively. If the American Opportunity Credit is taken, the Lifetime Learning Credit cannot be taken.
- **The Lifetime Learning Credit:** The lifetime learning credit is a credit of up to $2,000 for qualified education expenses paid for all eligible students included on a taxpayer's tax return. There is no limit on the number of years the lifetime learning credit can be claimed, and the student does not have to enroll in a minimum number of hours to claim the credit. If a taxpayer's MAGI is above $69,000 for single filers or $138,000 for joint filers, then the credit cannot be claimed. Only a partial credit is available for those with MAGI above $59,000 and $118,000, respectively. If the Lifetime Learning Credit is taken, the American Opportunity Credit cannot be taken.
- **Solar Investment Tax Credit:** The Solar Investment Tax Credit allows taxpayers to deduct 26% of the cost of installing a solar energy systems from his/her federal taxes. The Solar Tax Credit applies to both residential and commercial systems, and there is no cap on its value.
- **Earned Income Tax Credit:** The Earned Income Tax Credit is a credit for working taxpayers with low to moderate income. In order to qualify, the taxpayer must have earned income from working for someone or from running his/her own business and, must either have a qualifying child, or be between ages 25 and 64.

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