Tax Credit

A tax credit is a provision that reduces a taxpayer's final tax bill, dollar-for-dollar. A tax credit differs from deductions and exemptions, which reduce taxable income, rather than the taxpayer's tax bill directly.

How Is Tax Liability Calculated?

Line Item	Scenario 1: Using the Standard Deduction	Scenario 2: Using Itemized Deductions	
Adjusted Gross Income	**$125,000**	**$125,000**	← Their **Adjusted Gross Income (AGI)** is their combined income but not the amount they pay taxes on
Minus the Standard Deduction	$24,800		Their **standard or itemized deductions** reduce the amount of income they pay taxes on
or Minus Itemized Deductions		$28,000	
Equals their Taxable Income	**$100,200**	**$97,000**	← This is their new "**taxable income**." Note the $3,200 difference because of the itemized deductions
Pay 10% up to $19,749	$1,975	$1,975	The tax brackets apply a different or "marginal" rate to progressively higher levels of their taxable income.
Pay 12% from $19,750 to $80,249	$7,260	$7,260	
Pay 22% from $80,250 to $171,050	$4,389	$3,685	
Total Tax Liability Before Credits	**$13,624**	**$12,920**	← Adding up their "marginal" tax amounts equals their tax liability before credits
Minus Child Tax Credit (2 x $2,000)	$4,000	$4,000	← Tax credits reduce their tax liability by the amount of the credit
Income Tax After Credits	**$9,624**	**$8,920**	← This is their final tax bill after taking their deductions and credits into account
Average Tax Rate	9.6%	9.2%	

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What Types of Credits Are There?

Tax credits can be divided into two types: Refundable and nonrefundable. A refundable tax credit allows a taxpayer to receive a refund if the credit they are owed is greater than their tax liability. A nonrefundable credit allows a taxpayer to only receive a reduction in their tax liability until it reaches zero.

How Do Tax Credits Work in Practice?

Suppose a taxpayer, Chris, who has one dependent, comes to the end of the filing process and owes the IRS $1,300 (his tax liability). A tax credit would reduce this amount owed by the amount of the credit the taxpayer is eligible for. In this case, Chris would want to claim the Child Tax Credit, which is valued at a maximum of $2,000 per child ($1,400 of which is refundable). If he took no other credits and met the income thresholds, Chris would receive a $100 refund (see example A).

Let's assume that Amy is a taxpayer who cares for her elderly mother (see example B). Under current law, Amy may qualify for the Child and Dependent Care Tax Credit (CDCTC), which reaches its maximum at $1,200. Amy has $1,000 in tax liability. If she meets the income thresholds, is eligible for the maximum credit, and takes no other credits, she will not owe the IRS any taxes. Even though the maximum credit is greater than her total tax liability, because the CDCTC is nonrefundable, the credit can only reduce her liability until it reaches zero.

Refundable Credit (Example A)	**Nonrefundable credit (Example B)**
Chris' Tax Liability = $1,300	Amy's Tax Liability =$1,000
Apply the Child Tax Credit ($2,000 total; $1,400 refundable)	*Apply the Child and Dependent Tax Credit (CDCTC):* $1,200 total
$1,300-$1,400 = -$100	$1,000 – $1,200 = -$200
Chris' Refund = $100	Amy's Liability: $0 (Amy has no refund because the credit is nonrefundable)

Because refundable credits often result in refunds, they are more expensive in terms of lost revenue.

Tax Credits vs. Tax Deductions

Tax credits directly reduce tax liability dollar-for-dollar, while tax deductions reduce tax liability by the amount deducted multiplied by the taxpayer's marginal tax rate. For those in the lower income quintiles, tax credits are more valuable than deductions, since there is less income to deduct and refunds provide more disposable after-tax income. By contrast, deductions are preferred by higher-income taxpayers since they are subject to higher marginal tax rates on income they would otherwise exclude.