Tax Credits vs. Tax Deductions – Mullooly Asset Show Ep. 56 Transcript

Tom Mullooly: In episode 56, we talk about tax deductions versus tax credits.

Welcome to the Mullooly Asset Show. I'm your host, Tom Mullooly, and this is episode number 56. We get a lot of questions that come in, not all of them make it into a video. I don't know though if you've been paying attention on our website. We've been carrying podcasts. You can also find them on iTunes as well. That's where we also cover questions that we get. They're great financial planning topics. If you think that you've got a topic, you're probably not the only one who's thought of it. Get in touch with us. You may wind up seeing it on a video or on a podcast.

Tim, what are we going to talk about today?

Tim Mullooly : What's the difference between a tax credit and a tax deduction?

Tom Mullooly: Okay. This is a question that a lot of people should know but don't. There are tax deductions and then there's tax credits. They're completely different things. If you own a business, a lot of your business expenses are deductible, they're a tax deduction, or a part of it may be a tax deduction. If you're filing a personal return, you may make a charitable contribution. Part of that may be deductible, but don't misunderstand. There's a big difference between tax deductions and tax credits. Let's cover deductions first.

If you have, say, a $1000 deduction for something, some expense, and you're in the 28% tax bracket, what this does is it lowers, the tax deduction lowers, your taxable income. Another way of looking at it is if you're in the 28% tax bracket and you have a $1000 tax deduction, that deduction is going to lower your taxes by about $280 because you're in the 28% tax bracket. Deductions lower your taxable income. Everybody with me so far?

What's a tax credit? A tax credit, just set it aside while you're doing your taxes or having your taxes done because tax credits don't come into play until the very end of your tax return. Just fill out your tax return, or have your accountant or tax preparer fill it out, like normal. When you get to the bottom line of what taxes you owe, that's when you turn in your tax credit. If you had a $5000 bill in terms of taxes owed, and you have a $1000 tax credit, you now owe just $4000. Tax credits carry way more weight and far more impact than a tax deduction would. It's important to know these are huge, huge differences between the two.

Tax credits, a lot of times if you make too much money, you're not going to qualify for them. The other thing with tax credits is they tend to be temporary. A lot of times, at least in the past, Congress, as part of a tax bill to get the economy moving, would issue tax credits. They're short time, short term, bursts to help businesses invest, put capital to work, to maybe get individuals to spend money because they get a tax credit. It's a short term boost to get the economy moving. Tax deduction is more of a long term thing.

When you hear Congress talking about how they're going to change what can be deducted off of personal tax returns, don't listen to them. Just don't bother because you're talking about changing the structure of the US income tax codes. That is like trying to move a mountain. It's impossible. Not impossible, but it's very difficult to do. It's a huge undertaking.

Now we know the difference between a tax deduction and a tax credit. Let me show you an example of a tax credit. There's now something called the American Opportunity Tax Credit. In the last few years, you might have heard of it referred to as the HOPE Scholarship. The whole idea behind the HOPE Scholarship is a student who's going to a post-secondary education, post-secondary, after high school, so if you're going to a post-secondary education, you can get a tax credit of up to $2500. It's a big deal. The HOPE Scholarship, when it was first created, was for two years. It is now four years. If you're a senior in high school, you can use this thing four times. Pretty powerful. $10,000 in tax credits. We know how powerful a tax credit can be.

What can you use it for? You can use it for tuition. You can use it for books. You can use it for other expenses. You can't use it for room and board. There are some limitations on some of these "expenses", so you want to make sure you read the fine print, but this is something that really makes a lot of sense, especially if you're in a family that's got high school students about to go into college. It's important that you know about this.

There are some income thresholds. If you're a single filer and you have modified adjusted gross income of $80,000, you're in good shape. If you're a single filer and you have modified adjusted gross income of over $80,000, it starts to phase out fast. If you're a joint filer, you have to have modified adjusted gross income below $160,000. After you get to $180,000, it phases out between $160,000 and $180,000 of modified AGI. After $180,000, you make too much money, you can't use the tax credit. That's a great example of a tax credit that can be used.

You can get deductions for tuition paid, so it's important to run both tests. "Am I going to save more money on my taxes by getting this tuition deduction, or do I get more by using the American Opportunity Tax Credit?" I used to call it HOPE Scholarship, so I wanted to make sure I got the lingo right. Look. You got to run both tests. You got to know. This is why you don't do your own taxes. Get someone. Get a professional to do this for you. Don't do your own taxes. You can miss stuff like this.

That's it for episode 56. This was a good one. Deductions versus credits. It's important to know the difference. Tune back in for episode 57. Thanks for watching.

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