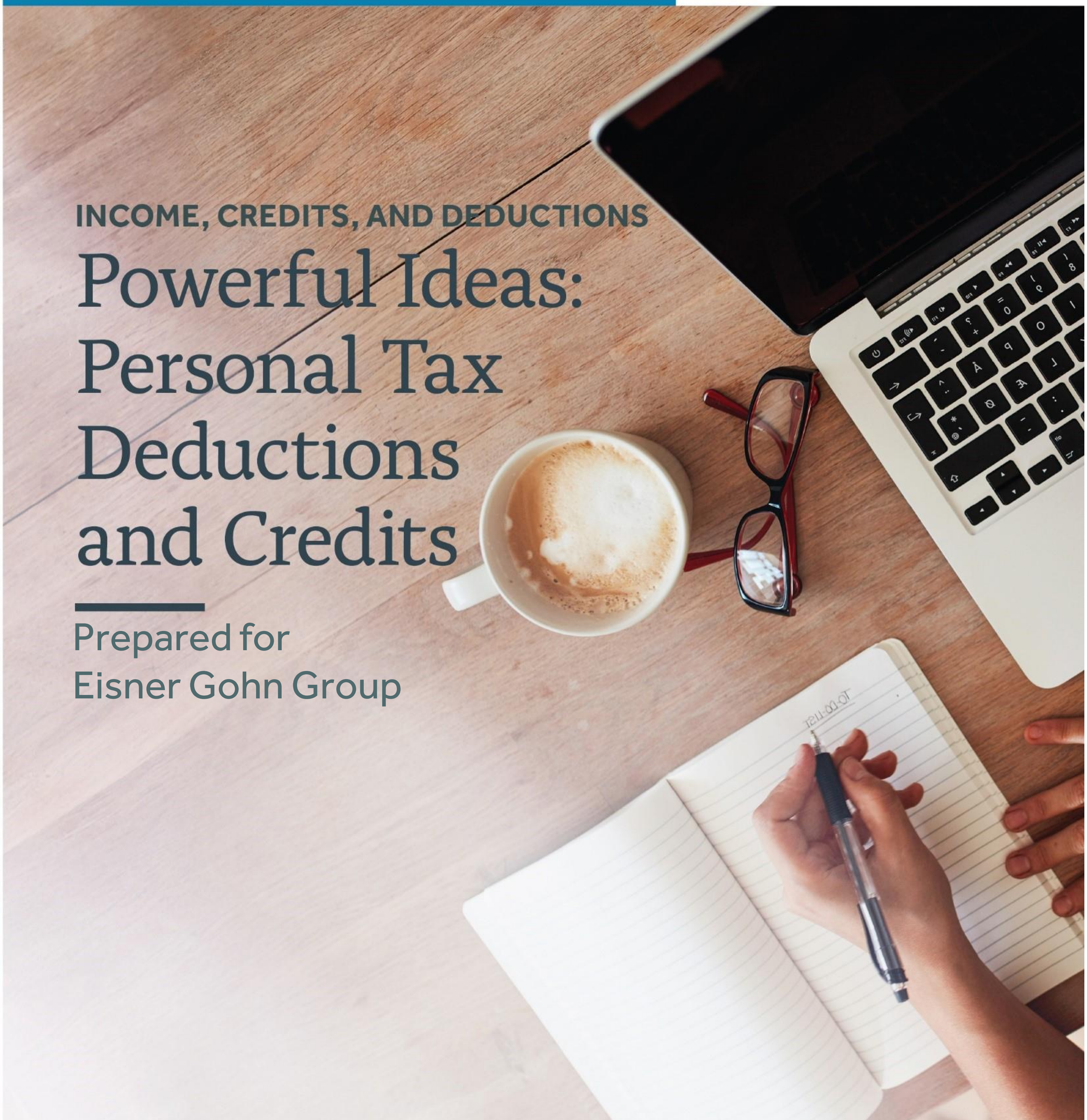

INCOME, CREDITS, AND DEDUCTIONS

Powerful Ideas: Personal Tax Deductions and Credits

Prepared for
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Personal Tax Deductions and Credits

Income tax deductions and income tax credits – in general

An income tax deduction reduces 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, the taxpayer will save 24 cents of taxes.

An income tax credit reduces the amount of tax that a taxpayer will be required to pay and may even result in the taxpayer receiving a refund. For example, if after adding up all taxable income and deductions, a taxpayer owes a tax liability of $10,000 and has tax credits of $5,000, the taxpayer will pay taxes of only $5,000.

What income tax deductions are available for individuals?

There are two primary types of deductions available to taxpayers: "above-the-line" deductions and "below-the-line" deductions. Above-the-line deductions, officially known as "adjustments to income," are subtracted from a taxpayer's gross income before calculating adjusted gross income (AGI). This makes them particularly useful because many other tax deductions and credits have income limits based on the taxpayer's AGI. Below-the-line deductions reduce the taxpayer's AGI but generally do not affect other deductions and credits that may be limited by the taxpayer's AGI.

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. For 2025, 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 $85,000 (for single taxpayers) and $170,000 (for married filing jointly). The deduction is phased out if income is between $85,000 and $100,000 ($170,000 and $200,000 for married filing jointly) and cannot be claimed if income exceeds $100,000 (or $200,000 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 2025, contributions to HSAs are limited to $4,300 for individuals and $8,550 for families. Individuals 55 and older are able to make an additional $1,000 contribution.
- **Deduction for contributions to IRAs:** Contributions to IRAs of up to $7,000 may be deductible in 2025. Individuals 50 and older may make an additional $1,000 of deductible catch-up contributions. Deductibility depends on income levels and whether the taxpayer or their spouse is covered by an employer retirement plan.

Taxpayers have the choice to either take the standard deduction or itemize their below-the-line deductions on Schedule A. The standard deduction is a fixed dollar amount provided by statute that allows a taxpayer to reduce their taxable income and varies by filing status. The standard deduction for married couples filing jointly for tax year 2025 rises to $30,000, up $800 from the prior year. For single taxpayers and married individuals filing separately, the standard deduction rises to $15,000, and for heads of households, the standard deduction will be $22,500. Generally, taxpayers will elect to take the standard deduction unless their total itemized deductions are greater than the standard deduction available for their filing status.

Below-the-line (itemized) deductions include the following:

- **The mortgage interest deduction:** Taxpayers who own a home can 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 may deduct either state and local income taxes, or state and local sales taxes, in addition to state and local real property taxes and personal property taxes. The combined deduction for state property and income taxes is capped at $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. For 2021, taxpayers could claim up to $300 (for single filers) or $600 (for married couples filing jointly), regardless of whether they itemized deductions. This provision was not extended beyond 2021, however, so there is no longer a tax benefit for charitable gifts if the taxpayer elects to take the standard deduction.

What income tax credits are available for individuals?

The following are some of the most common tax credits available to individual taxpayers in 2025:

- **Child tax credit:** The child tax credit is a federal tax benefit that plays an important role in providing financial support for taxpayers with children. For 2025, taxpayers with children under the age of 17 may be eligible to claim a tax credit of up to $2,000 per qualifying child, and $1,500 of that credit may be refundable. If the taxpayer's modified adjusted gross income exceeds $400,000 (married filing jointly) or $200,000 (all other filers), the credit will be reduced by $50 for each $1,000 of income exceeding the threshold until it is eliminated. The 2021 child tax credit gave families larger sums: up to $3,600 per child under age 6, and up to $3,000 per child ages 6 through 17, and up to half of those sums were available through monthly payments, while families could file for the rest of the money (or the entire sums if they did not receive monthly checks) with their 2021 tax returns. Now, the child tax credit has reverted to the previous rules.

- **Education tax credits:** For 2025, taxpayers with current education expenses for themselves or a dependent may be eligible for one of two education credits. The American Opportunity Tax Credit (AOTC) is available for up to four taxable years for students enrolled at least half-time who are pursuing a degree or credential. The AOTC has a maximum value of $2,500 per student per year (up to $10,000 in tax relief over four years). The credit provides a 100% match for the first $2,000 of eligible expenses and a 25% match for the next $2,000 of eligible expenses. Forty percent of the resulting credit, thus a maximum of $1,000, is refundable and available to all taxpayers with expenses regardless of tax liability. The remaining 60% is nonrefundable.

  The Lifetime Learning Tax Credit (LLTC) is available for an unlimited number of years of education and does not require that the qualifying students be pursuing a degree or credential. The LLTC has a maximum value of $2,000 per tax return. It is calculated as a 20% match of up to $10,000 of expenses per return. Unlike the AOTC, it is nonrefundable and therefore it is not available to many low-income families. Both credits phase out for taxpayers with modified adjusted gross income between $80,000 and $90,000 (between $160,000 and $180,000 for joint filers).

  Only education spending net of other tax-preferred education assistance, such as grants, scholarships, or distributions from education savings accounts, qualifies for a credit. Qualifying expenses do not include living expenses, such as room and board. Taxpayers can claim the credits for their own expenses or the expenses of a dependent child or relative. Although in general a dependent child must be less than 19 years old, the age limit is extended through 23 years for full-time students. Thus, in general, the education expenses of traditional college students can be claimed by their parents. The income phaseouts for the American opportunity tax credit and lifetime learning tax credit are not adjusted for inflation.

- **Energy-related tax credits:** To encourage Americans to use solar power, the government offers tax credits for solar-powered systems. Under prior legislation, the Federal Solar Investment Tax Credit was set to drop down from 26% in 2022 to 22% in 2023. Under the Inflation Reduction Act of 2022, homeowners will be able to claim 30% of the cost of a home solar installation as a tax credit until 2032. After that, the credit steps down to 26% in 2033 and then 22% in 2034, expiring thereafter. The new law also revived and modified two energy-related credits for homeowners.

The existing Nonbusiness Energy Property Credit was revived for 2022 and restructured as the Energy Efficiency Home Improvement Credit beginning in 2023. This credit is generally equal to 30% of a homeowner's qualified energy efficiency improvement costs, residential energy property expenditures for qualified energy property, even if the taxpayer does not own the home, and a homeowner's home energy audit costs. Previously limited to a total lifetime credit of $500, the credit no longer has a lifetime limit but is subject to annual limits based on the type of property.

- **Earned income tax credit:** The earned income tax credit (EITC) is a credit for low- to moderate-income workers and families. To qualify, the taxpayer must have earned income from working for someone or from running their own business and must either have a qualifying child or be between ages 25 and 64. The maximum earned income tax credit amount will be $8,046 in 2025 for certain taxpayers who have three or more qualifying children.
- **Tax Credit for IRAs and Retirement Plans:** The "saver's credit" allows some low- and middle-income taxpayers to claim a partial, nonrefundable income tax credit for contributing to certain tax-deferred retirement savings vehicles. The tax credit is available for elective contributions made to traditional IRAs, Roth IRAs, and the following employer-sponsored retirement plans: Section 401(k) plans, Section 403(b) annuities, Section 457(b) plans, SIMPLE plans, and SEP plans. Voluntary after-tax employee contributions made to a qualified retirement plan also qualify for the credit. Taxpayers can claim the credit only if their AGI for 2025 is $79,000 or less if married filing jointly, $59,250 or less if head of household, or $39,500 or less if any other status. The maximum annual contribution eligible for the tax credit is $2,000, and the maximum credit rate is 50% of the amount contributed. This means that the maximum possible credit that a taxpayer could receive in one year is $1,000.

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