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# Tax Fundamentals: How Deductions and Credits Shape the Outcome

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In our previous discussion on how income flows through the tax system, we introduced income as the starting point of the calculation. That naturally raises the follow-up question – if income determines where the calculation begins, what actually changes the result?

This question surfaced in a recent conversation with a client who had recently begun managing her finances independently. As we reviewed her return, she paused on two lines that appeared to be doing the same thing.

"I see a standard deduction here, and then these credits at the bottom," she said. "They both lower my taxes, right? So, are they basically the same?"

It is a common point of confusion. Both deductions and credits reduce taxes, but they do so in different ways, and that distinction can influence the outcome. While they often appear similar on the surface, they operate at different stages within the same framework.

This discussion is most relevant for individuals who are beginning to manage their own finances or seeking to better understand how deductions and credits function within the tax system, and how they influence the final result.

## DEDUCTIONS: ADJUSTING THE INCOME BEING TAXED

Deductions reduce the amount of income that is subject to tax.

Once total income is calculated, deductions are applied to determine taxable income, which is the portion used to calculate how much tax is owed. In this way, deductions do not reduce taxes directly. They adjust the starting point on which the calculation is based.

There are two primary ways this reduction occurs, through the standard deduction or itemized deductions.

The standard deduction is a fixed amount determined by filing status and is the approach many individuals use. Itemized deductions, by contrast, are based on specific expenses such as mortgage interest, state and local taxes, and charitable

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contributions.

The tax system does not require a choice between the two. It effectively applies whichever produces a larger reduction. For many individuals, this means the standard deduction is used by default because it exceeds the total of itemizable expenses. Itemizing becomes relevant only when those expenses collectively exceed that threshold.

From a structural perspective, deductions operate early in the calculation. Because they reduce income before tax is applied, their impact depends on the rate applied to that income, rather than reducing tax liability directly.

## CREDITS: ADJUSTING THE TAX ITSELF

Credits reduce the amount of tax owed.

After tax is calculated based on taxable income, credits are applied to reduce the final liability. This is the key distinction. Credits operate after the main calculation rather than before it.

Some credits reduce tax liability dollar for dollar. Others may be partially refundable, meaning they can provide a benefit even if no tax is owed.

Common examples include education credits, child-related credits, and certain energy incentives, each with their own eligibility and phaseout rules. Because credits apply at the end of the calculation, their impact is more direct. A one-dollar credit reduces tax liability by one dollar. Unlike deductions, which depend on tax rates to determine their impact, credits apply directly to the calculated liability.

## HOW THE PIECES FIT TOGETHER

The distinction between deductions and credits becomes clearer when viewed within the full calculation.

Income is calculated first. Deductions are applied to determine taxable income. Tax is calculated based on that amount. Credits are then applied to reduce the final liability.

**For Example:** A $1,000 deduction reduces the income being taxed. If that income falls within a 24% tax bracket, the deduction reduces tax by approximately $240. A $1,000 credit, by contrast, reduces tax liability directly by $1,000.

This is why two provisions that appear similar can have very different impacts depending on where they apply within the calculation.

For individuals reviewing a return, these steps are not always immediately apparent. Deductions and credits appear in different sections, which can make the process feel fragmented even though it follows a consistent structure.

Two individuals with similar income may arrive at different outcomes depending on how these elements apply. One may benefit more from deductions, while another may qualify for credits that directly reduce what is owed.

In practice, income determines exposure to tax, while deductions and credits determine how much of that exposure ultimately translates into a tax due or refund amount. Timing decisions, account types, and eligibility thresholds introduce additional layers that affect how and when these reductions apply.

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## PLANNING IMPLICATIONS: WHERE REDUCTIONS ACTUALLY MATTER

For the client sitting across the table, the distinction between deductions and credits made the return easier to interpret.

What initially appeared to be similar line items were, in practice, affecting different parts of the calculation. The standard deduction reduced the income being taxed, while the credits reduced the tax itself.

From a planning perspective, the distinction is less about identifying every available deduction or credit, and more about understanding where each applies within the calculation. Not all deductions or credits carry equal weight, and their impact depends on income levels, applicable tax rates, and how they interact with structural thresholds.

This is why two individuals with similar incomes may still experience different outcomes.

Over time, the mix of deductions and credits may change as income and circumstances evolve, but the structure through which they are applied remains consistent.

While deductions and credits adjust the outcome, the way that outcome is calculated, through tax brackets and the way taxes are paid throughout the year, introduces another layer to the system, which will be explored in our next article.

Understanding where and how these reductions apply impacts tax efficiency and can be an effective tool for long-term planning.

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