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How Much Is Your Tax Deduction Worth?

For many, this tax return filing season just came to a close. When you or your accountant hit send to e-file or you licked that last stamp–hopefully certified mail–you may be done 'til next year. For many others, an automatic extension means you now have six more months to attend to this duty.

But on whichever side of the filing line you find yourself, it's worth revisiting some universal truths about deductions. We all have our own peccadilloes about them. We may fear particular deductions (say a home office) will trigger an audit.

Perhaps we can't stand spending money on something–say first class airfare–unless we can find a way to deduct it. Tax deductions may drive our every move, like an accountant recently profiled in the Wall Street Journal.

But it's surprising how many people don't seem to understand the basic math. One Seinfeld episode poked fun at what Americans think about tax write-offs:

> Kramer: "It's just a write-off for them."
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> Jerry: "How is it a write-off?"
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> Kramer: "They just write it off."
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> Jerry: "Write it off what?"

Kramer: "Jerry, all these big companies, they write-off everything."

Jerry: "You don't even know what a 'write-off' is."

Kramer: "Do you?"

Jerry: "No. I don't."

Kramer: "But they do, and they are the ones writing it off."

Deducting something doesn't make it free. In contrast, a tax ***credit*** is a dollar-for-dollar reduction of tax. But to see how much a deduction is worth you must know your marginal tax rate. If your company pays a 35% tax rate, a $100,000 Christmas party is not free. It still costs $65,000, the amount remaining after the taxpayers cover the other $35,000.

In that sense, the hoopla may sometimes seem overblown. Some people get so embroiled in the process of trying to claim deductions that they don't consider the basic math. Others spend money on deductible items as if it is ***completely*** paid for by the government. Such myopia is understandable considering the dizzying complexity of many deductions and computations. Even the home mortgage interest deduction can be confusing. See Calculating The Mortgage Interest Deduction.

Assume your mortgage payment is $2,000 per month, it is all interest, and your top tax rate is 35%. You might think that after-tax, your mortgage payment really only costs you $1,300 (after subtracting the $700 benefit you receive from deducting the interest). But mortgage interest is an itemized deduction, so you get no benefit if you don't itemize. Plus, if your income is too high you are subject to "phase-out," meaning your deductions are trimmed.

An even better example involves our old friend the alternative minimum tax ("AMT"). Many deductions are available against the regular tax but not against AMT. Say you pay your lawyer $10,000 to help you through a job-related legal problem but your employer won't reimburse you. No problem, you say, you'll deduct it. Paying 35% tax you might assume your after-tax cost is $6,500, and that the government will pick up the other $3,500.

Nope. Your deduction is only available to the extent all of your miscellaneous itemized deductions combined ***exceed*** 2% of your adjusted gross income. So if you make $100,000, the first $2,000 can't be deducted. Second, while your deduction counts against regular tax, it ***does not count for purposes of AMT***. Millions of taxpayers pay AMT, and you often can't determine whether you will until tax return time. The answer may be no deduction for your legal expenses.

For more, see:

IRS Tax Topics – Itemized Deductions

Common tax breaks for families, individuals

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