Written by **Laurence M. Vance** on April 24, 2013

The Importance of Tax Deductions

The United States personal income tax filing season has officially ended. No more forms, no more schedules, no more instructions, no more H&R Block and TurboTax commercials, and no more roadside signs advertising tax preparation services that specialize in getting you the maximum earned income credit.

There are two other tax-related items that will be going away as well, at least in part, but unlike forms, schedules, instructions, commercials, and signs, they won't be returning next year. In the case of these two items, however, their absence will not be a good thing.

Tax exemptions and tax deductions serve to reduce one's income subject to tax. Exemptions and deductions work the same way, but deductions are generally subject to more limitations, conditions, and exclusions. Both differ from tax credits in that tax credits serve to reduce the amount of tax owed on one's income. Either way, one will pay less in taxes the greater the number, and the greater the amount, of exemptions, deductions, and credits that he qualifies for.

Under current tax law, each taxpayer is entitled to one personal exemption for himself, his spouse, and each of his dependents. Dependents don't necessarily have to be minor children, but can include children under 24 who are full-time students and don't provide more than half of their own support, qualifying relatives who live with the taxpayer, and even the taxpayer's parents who don't live with him if the taxpayer provides more than half of their support. The amount of each exemption for tax year 2012 was $3,800.

There were a number of tax deductions available for tax year 2012 that one might have qualified for. Some of these are permanent (at least until such time as Congress changes the tax code), and some of them are temporary and subject to change from year to year.

For 2012 there were deductions for educator expenses, business expenses of performing artists, health savings accounts, moving expenses, the deductible part of self-employment tax paid, health insurance premiums paid by the self-employed, IRAs, tuition and fees, and student loan interest. But even if the taxpayer didn't qualify for any of these deductions, there is the standard deduction of $5,950 ($11,900 for married filing jointly) that was available to everyone. Taxpayers (and their spouses) who are age 65 or older on the last day of the tax year or legally blind receive an extra $1,150 for each of those circumstances.

For those who chose to itemize deductions instead of taking the standard deduction, there were also available deductions for medical expenses, state and local taxes, real estate taxes, mortgage interest, mortgage insurance premiums, charitable contributions, casualty or theft losses, unreimbursed employee expenses, and tax preparation fees.

Qualifying for personal and dependent exemptions and just the standard deduction effectively means that the first $27,100 in income of a typical family of four is not subject to federal income tax.

Clearly, since the income tax is not up for elimination, the maximum tax rate will almost certainly never return to its initial 7 percent, and tax rates are unlikely to be reduced any time soon, tax exemptions and deductions are important, and especially for low- and moderate-income taxpayers. But since there are a large number of taxpayers in those categories, and much fewer that are considered medium- and high-income taxpayers, the government can more easily eliminate or reduce the tax deductions of the latter groups, usually with the full support of the former groups, to raise more revenue under the guise of making "the rich" pay their "fair share."

This is just what happened in the American Taxpayer Relief Act of 2012 that was passed by Congress at the beginning of the tax season.

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) and the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA) — more popularly known as the Bush tax cuts — lowered the income-tax brackets to 10, 15, 25, 28, 33, and 35 percent, increased the child credit to $1,000, lowered the long-term capital gains and qualified dividend tax rates to 15 percent, increased the Section 179 expense deduction for small businesses to $250,000, and gradually eliminated the estate tax.

All of these provisions were set to expire at the end of 2010. But as part of a deal to extend the so-called Bush tax cuts, Congress enacted some temporary tax measures in the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (TRUIRJCA). The six tax brackets and the rates on dividends and capital gains were extended for two years, along with the $1,000 child credit and certain other tax credits. The Section 179 expense deduction was extended and increased. However, the estate tax, one of the few taxes in history that had actually been eliminated, was revived with a $5 million exemption and a maximum rate of 35 percent.

But because these measures were only temporary, another fix was deemed necessary by Congress to avoid going over the so-called "fiscal cliff." The aforementioned American Tax Relief Act of 2012 made the Bush-era tax cuts permanent, but only for those making up to $400,000 a year ($450,000 for married couples), increased the top marginal tax rate to 39.6 percent, increased the estate tax to 40 percent, permanently indexed the alternative minimum tax to inflation, raised the top marginal tax rates on long-term capital gains and dividends to 20 percent for those making over $400,000 a year ($450,000 for married couples), extended for five years the expansion of the earned income credit, the child tax credit, and the American opportunity credit, and temporarily extended some other tax deductions and credits.

Also included in the American Tax Relief Act is the return of two provisions that few Americans have ever heard of: PEP and Pease. The PEP provision is the personal exemption phase-out and the Pease provision (named after Rep. Donald Pease, a Democrat from Ohio) is the limitation on itemized deductions. The income threshold for these provisions is $250,000 ($300,000 for married filing jointly).

PEP rescinds the benefit of the personal exemption from taxpayers who earn over the income threshold. Pease rescinds up to 80 percent of the value of certain itemized deductions of taxpayers who earn over the income threshold. The itemized deductions subject to the rule include three of the most common: home mortgage interest, state and local taxes, and charitable deductions. The two main itemized deductions that are excluded from the rule are already subject to their own limitations: Medical expenses and casualty or theft losses are limited to amounts over 10 percent of adjusted gross income.

(The medical expense exclusion used to be limited to only 7.5% of adjusted gross income, but it was raised to 10% as part of Obamacare.)

The PEP and Pease provisions were enacted as part of the Omnibus Budget Reconciliation Act of 1990 (OBRA90). Under the PEP provision, each personal exemption was phased out by a factor of 2 percent for each $2,500 by which a taxpayer's adjusted gross income exceeded $100,000 ($150,000 for married filing jointly). Under the Pease provision, certain itemized deductions were reduced by 3 percent of the amount by which a taxpayer's adjusted gross income exceeded $100,000 ($150,000 for married filing jointly), but could not be reduced by more than 80 percent. For tax years after 1991, the income threshold for both provisions was indexed for inflation. Although the PEP and Pease provisions were each supposed to expire after tax year 1995, they were made permanent in the Omnibus Budget Reconciliation Act of 1993 (OBRA93).

As part of the Bush tax cuts, the PEP and Pease provisions were phased out over the five-year period from 2006 to 2010. For tax years 2006 and 2007, their effect was reduced by one-third; for tax years 2008 and 2009, their effect was reduced by two-thirds; for tax year 2010, they were completely eliminated. The extension of the Bush tax cuts for tax years 2011 and 2012 meant that the elimination of the PEP and Pease provisions was also extended. But now, thanks to the American Tax Relief Act, they are back in full force.

But even without the PEP and Pease provisions, the government was already targeting "the rich" — that is, the people who pay the bulk of U.S. income taxes, through the phase-out of certain deductions and credits. This means that the value of many deductions and credits are reduced as income rises, and in some cases are disallowed altogether. This includes the child credit, the child and dependent care credit, the retirement savings contributions credit, the IRA contribution deduction, the student loan interest deduction, the tuition and fees deduction, the adoption credit, lifetime learning credit, the American opportunity credit, and the earned income credit.

For example, for tax year 2012, up to $2,500 of student loan interest paid is normally tax deductible. However, this deduction begins to be phased out once an individual's modified adjusted gross income exceeds $60,000 ($125,000 if married filing jointly), and is not allowed at all once income reaches $75,000 ($155,000 if married filing jointly).

The American Tax Relief Act does not provide much in the way of tax relief. It keeps things the way they have been since 2010 for the majority of Americans (many of whom don't pay any federal income tax anyway), and punishes success by increasing the taxes of everyone else via increased rates and decreased deductions.

Lowering or eliminating tax deductions has the same effect as raising tax rates: higher taxes. But it enables members of Congress — Democrats and Republicans alike — to talk about how they are merely "closing loopholes," "reforming the tax code," or making the tax code "fairer" without raising taxes. What they really mean, of course, is that they are not raising the tax rates, for they are certainly raising taxes.

Tax deductions should certainly be eliminated — but this is only because the whole tax code should be repealed. The most critical thing is not that the tax rates are made flatter, fair, or less progressive, the tax forms are made simpler, or the tax code is shortened, but that the whole rotten system of institutionalized theft is done away with.

Because taxation is on its face immoral, the tax burden doesn't need to be shifted, the tax base doesn't need to be broadened, tax loopholes don't need to be closed, the "rich" don't need to pay their "fair share," and the tax code certainly doesn't need any additional reform.

But until the income tax is eliminated once and for all, the importance of tax deductions cannot be emphasized enough. Tax deductions — and their cousins tax exemptions, tax credits, tax breaks, tax loopholes, and tax shelters — are one thing Americans have to help them keep more of their money in their pockets and out of the greedy hands of Uncle Sam. Any attempt by members of Congress — Democrat or Republican — to eliminate them should be seen as an attempt to raise taxes.

Tax deductions are not subsidies. They don't have to be "paid for." Yes, they deprive the government of revenue, but that is essential for a free society in which people are able to keep everything they earn and decide for themselves on what to do with it instead of the government deciding for them. Only a statist who believes the government has the right to a percentage of everyone's income would object to starving the beast that is the federal leviathan.

The fact that the government has used various tax deductions and credits to promote work (earned income credit), home ownership (mortgage interest deduction and first-time homebuyer credit), children (child tax credit), saving for retirement (IRA deduction and retirement savings contributions credit), adoption (adoption credit), domestic production (domestic production activities deduction), attending college (education credits), or electric vehicles (plug-in electric drive motor vehicle credit) is irrelevant.

It doesn't matter what the tax deduction is for, how much it is, whom it benefits, or why it was instituted; the result is the same — government takes less of our money to fund its bureaucrats, agencies, departments, bureaus, military adventures, global empire, corporate welfare, subsidies, welfare programs, income redistribution schemes, and myriad of wasteful, inefficient, and unconstitutional programs that shouldn't exist. Until the income tax is abolished, we need all the tax deductions we can get.