

Doron F. Eghbali TAX Law

Tax Vocabulary: Some of What We Should Know Now

Wednesday, September 22, 2010 by [Doron F. Eghbali](#)

To know our rights, it behooves us to understand some of the tax jargon often used by the media such as tax expenditures, tax gap or the difference between tax credits and tax deductions. Let us further explore these rather complicated concepts in a relatively simplified fashion.

WHAT ARE TAX EXPENDITURES?

To understand the concept of tax expenditures, we should first breathe and then imagine (rather eerily) the government owns whatever we earn. The portion of the money the government cannot keep and by law has to return to us, is an expenditure, that is an expense, to the government. Such expenditure is returned to us through exemptions, exceptions and different tax rates in tax law. These are tax expenditures.

WHAT IS TAX GAP?

Tax gap is the amount government is supposed to receive in tax income but does not receive because taxpayers either underestimate or overestimate their taxable income or do not file their return at all for various reasons.

WHAT IS THE DIFFERENCE BETWEEN TAX DEDUCTIONS AND TAX CREDITS?

The difference is rather straightforward and we should keep it as such.

1) TAX DEDUCTION

Tax deduction reduces your taxable income. This means if you have \$10,000 taxable income and \$500 in tax deduction, then your taxable income would be \$9,500. You then pay taxes on the \$9,500 based on your tax bracket. Therefore, the value of your tax deduction, to some extent, depends on your tax bracket. If you are in the highest tax bracket and have to pay around 40% of your taxable income to the IRS, then the tax deduction is worth more to you than somebody in the lowest bracket.

2) TAX CREDIT

On the other hand, tax credits reduce what you have to pay for taxes dollar for dollar. In other words, let us say you have calculated your taxable income and after taking into account your tax bracket now you have to pay \$10,000 in taxes to the IRS. Any tax credit you have, dollar for dollar reduces your taxes. If, let us assume, you have \$1,000 in tax credits, then you just have to pay \$9,000 in taxes.

BOTTOM LINE FOR TAX DEDUCTIONS AND TAX CREDITS

Both tax credits and tax deductions reduce your taxes, although tax credits are relatively better.

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