8.2 Income Tax

Income tax is a percentage of income collected by the government to fund its services and programs. Income tax is collected by the federal government and by most states. The Internal Revenue Service (IRS) enforces federal tax laws and collects taxes.

# Objective 1: Determine Gross Income, Adjusted Gross Income, and Taxable Income

The first step in determining tax liability (taxes owed) is determining income.

**VOCABULARY FOR DETERMINING TAXABLE INCOME**

**Gross Income** – Total income from all sources

**Adjustments** – Income that is tax-deferred or otherwise not taxable

**Adjusted gross income** – Gross income minus adjustments

**Exemption** – A fixed amount deducted from income for each person supported by the income

**Deduction** – Expense that, by tax law, may be deducted from income

Taxpayers select either itemized deductions or a standard deduction, whichever is greater.

**Itemized Deductions** – The taxpayer keeps detailed records of all allowable expenses.

**Standard deduction** - A simpler method using a fixed value for those who choose not to itemize.

**Taxable income** – Adjusted gross income minus the sum of exemptions and deductions

# Objective 2: Calculate federal income tax

Federal income tax is calculated from taxable income using a table like the one below. Each column represents a different filing status. The tax rates in the left column are assigned to various income ranges called margins. Each row represents a **marginal tax rate**, the rate on a portion of income. The more money a taxpayer makes, the higher the tax rate (percentage) paid on each additional dollar. This highest tax rate is the taxpayer’s **tax bracket.** Taxpayers may also be able to take advantage of **tax credits** which are deducted from the final tax calculation.

**DESCRIPTIONS OF FILING STATUSES**

**Single** – unmarried, divorced, or legally separated

**Married filing separately** – married and each partner files a separate tax return

**Married filing jointly** – married and both partners file a single tax return

**Head of household** – unmarried and paying more than half the cost of supporting a child or parent

Table 8.1 below gives 2012 marginal tax rates, standard deductions, and exemptions by filing status.

| **Tax Rate** | **Single** | **Married Filing Separately** | **Married Filing Jointly** | **Head of Household** |
| --- | --- | --- | --- | --- |
| 10% | up to $8700 | up to $8700 | up to $17,400 | up to $12,400 |
| 15% | $8701 to $35,350 | $8701 to $35,350 | $17,401 to $70,700 | $12,401 to $47,350 |
| 25% | $35,351 to $85,650 | $35,351 to $71,350 | $70,701 to $142,700 | $47,351 to $122,300 |
| 28% | $85,651 to $178,650 | $71,351 to $108,725 | $142,701 to $217,450 | $122,301 to $198,050 |
| 33% | $178,651 to $388,350 | $108,726 to $194,175 | $217,451 to $388,350 | $198,051 to $388,350 |
| 35% | more than $388,350 | more than $194,175 | more than $388,350 | more than $388,350 |
| Standard Deduction | $5950 | $5950 | $11,900 | $8700 |
| Exemptions  (per person) | $3800 | $3800 | $3800 | $3800 |

**FORMULAS FOR INCOME TAX CALCULATION**





# Objective 3: Calculate FICA taxes

**FICA** (Federal Insurance Contributions Act) taxes are used for Social Security and Medicare benefits. Employees (not self-employed) and employers each pay a portion of FICA taxes. The employee’s portion is withheld from each paycheck. Self-employed individuals are responsible for their total FICA tax.

Table 8.2 below gives 2012 FICA tax rates.

| **Employee’s Rates** | **Matching Rates Paid by the Employer** | **Self-Employed Rates** |
| --- | --- | --- |
| * 5.65% on first $110,000 of income * 1.45% of income in excess of $110,000 | * 7.65% on first $110,000 paid in wages * 1.45% of wages paid in excess of $110,000 | * 13.3% on first $110,000 of net profits * 2.9% of net profits in excess of $110,000 |

**Objective 4: Solve problems involving working students and taxes**

**Gross pay** (or base pay) is the amount of money earned during the time represented on each paycheck. For employees paid on an hourly basis, this is the number of hours worked times the hourly pay. The employer withholds a percentage for federal income tax, FICA, and state taxes. **Net pay** is the amount of money the employee actually receives for the pay period.