

Lecture 14: Chapter 4

Section 4D: Income Tax

The Basics

The hardest thing in the world to understand is the income tax.

– Einsetin

Definition 1. Gross income is defined to be all your income from the past year.

Definition 2. Adjustments are the portions of your gross income that are not taxable and your **adjusted gross income** is your income less your adjustments

Definition 3. Exemptions and deductions are amounts that you subtract from your adjusted gross income before calculating taxes. The amount left is your **taxable income**.

You may then use your taxable income in conjunction with a tax table to find the total tax you owe. If this amount is less than what has been withdrawn from your paychecks, you are entitled to a **tax refund**.

Deductions and Rates

You may either choose the **standard deduction** which pertains to your filing status, or **itemize** your deductions by adding all your deductions up separately (charity, home mortgage interest, etc.)

The United State of America has a **progressive income tax** meaning the higher your taxable income, the more you pay.

Table 4.10 on page 272 gives deductions and tax rates for the four filing status options in different margins of income.

Example 1. Assume Mike is a single student with no dependents who makes \$13000 a year. How much tax does he pay?

Example 2. Assume Bob and Sue made \$80,000 last year and are married with 3 dependents and file jointly. How much tax do they pay?

Definition 4. Tax credits reduce your total tax by a given amount where deductions only reduce your taxable income.

FICA

Some income is also subject to **FICA**. These taxes are used to pay Social Security and Medicare benefits, primarily to retired people. These are only taken out of wages.

In 2003, FICA tax rates were calculated by the following:

7.65% on the first \$87,000 of income from wages

1.45% on any income from wages in excess of \$87,000.

In addition your employer is requires to pay matching amount of FICA taxes.