

The Basics of Taxes

Advanced Level

Ben Franklin once said, "But in the world nothing can be said to be certain except death and taxes." **Taxes** are a sum of money that a government mandates that its citizens pay in order to support the government itself and all of its services. You are considered a **taxpayer in the United States if you live here and** pay taxes to national, state, county or municipal (city/town) governments.

Taxpayers are voters!

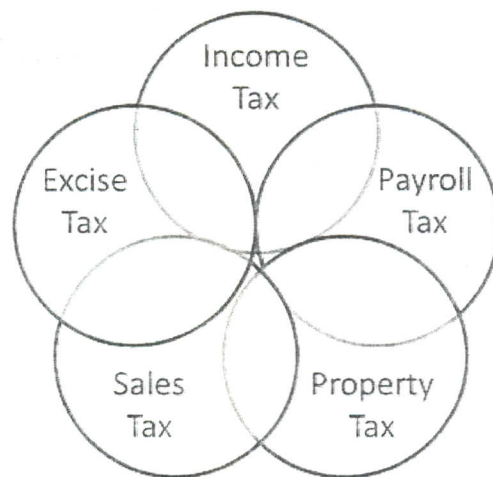
So, how do you benefit from the taxes you pay?

The answer is based in the principle that you are better off being a member of a community than by yourself. A **community** is a group of people with common interests and concern for the common good. The United States, along with your state, county, and city/town are all communities. Taxes provide the means for a community to fund the creation of roads, public schools, libraries, police and fire departments, military for national security, government benefit programs, recreation (such as parks and trails), and much more. Without taxes, it would be difficult for you to individually produce or purchase many of the benefits that come to you as a member of a community. Chances are that you have already benefited from taxes in some way today.

What are three ways you have benefited from taxes today?

- 1.
- 2.
3. ?

Taxes are charged in a variety of ways. Types of taxes include: income tax, payroll tax, property tax, sales tax, and excise tax.



Income Tax

Income tax is a tax on earned and unearned income. **Earned income** is money earned from working for pay. Wages and salaries earned from employment are examples of earned income. **Unearned income** is income received from sources other than employment. Interest earned from a savings account or investment is an example of unearned income. Income taxes are charged by the federal government and most state governments, as well as some local governments.

Federal Income Tax

Most income earned by people in the U.S. is subject to federal income tax. However, the amount of federal income tax you pay depends on the amount of income you earn. The higher your income, the more federal income tax you pay.

Federal income tax helps fund programs sponsored by the federal government, including the operations of the three federal government branches (executive, legislative, and judicial). National defense, the federal court system, food safety regulation, air traffic control, highway construction, and an array of programs that assist residents in times of need are just a few examples of federally funded government programs made possible by the collection of federal income taxes.

State Income Tax

Individual states have the option to charge their citizens a state income tax. Some states do not have a state income tax. Just as with federal income tax, state income tax is determined by the amount of your earned and unearned income.

Specific uses for state income tax vary per state. Many states spend the majority of their state income tax revenue on education and health care, but there are many other important uses for this money, such as the development of state highways as well as fund the operations of the state government.

Payroll Tax

A **payroll tax** is a tax on earned income. This tax deduction from your paycheck supports both the Social Security and Medicare programs, dictated by the Federal Insurance Contributions Act (FICA). Therefore, these taxes are sometimes referred to as the FICA tax. Both taxes charge a set percentage of a person's earned income.

Payroll taxes are automatically deducted from your paycheck. However, if you are self-employed you are responsible for paying for your tax contributions toward these two programs.

Social Security

The Social Security payroll tax helps fund the Social Security program. Social Security is a federal government program that helps citizens fund retirement, as well as helps people who have a profound disability, are under the age of 18 and experience the premature death of a parent, or the death of a spouse in a family with minor children. Your tax contribution toward Social Security is 6.2% of your earned income. The cumulative maximum amount of this tax contribution from your paycheck varies from year to year.

Medicare

The Medicare program is federally funded through a Medicare payroll tax. The program's main purpose is to help pay for health care for senior citizens in the U.S. A person's tax liability is 1.45% of their earned income and there is no annual limit.

Have you received a paycheck? If so, how much did you pay in income tax? How much did you pay in payroll tax?

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In addition to deducting Social Security and Medicare taxes from an individual's earned income, employers are required to match their employees' tax contributions. For example, if an employee owes \$100 for Social Security and Medicare taxes, the employer will deduct this amount from the employee's paycheck. Then, the employer will pay the government a total of \$200 (\$100 for the employee's portion of the tax and \$100 for the employer's portion of the tax). Self-employed people must pay both the employee and employer Social Security and Medicare contributions.

Employee contribution:
\$100

Employer contribution:
\$100

Employer pays \$200 in payroll taxes

The differences between income tax and payroll tax are summarized in the table below:

Income Tax	Payroll Tax
Paid on both earned and unearned income	Paid on only earned income
Amount paid depends on many different factors but increases as income increases	A set percentage of earned income is paid
Funds many different operations and programs of the federal government	Funds the Social Security and Medicare programs

Property Tax

A **property tax** is a tax on property, such as land, buildings (including homes), and motor vehicles (automobiles, boats, etc.). The fee paid to license an automobile is a property tax. Owners of homes, land, and buildings receive a property tax bill. Most property taxes are paid annually.

Property taxes are charged by state and/or local governments to pay for local schools and other expenses. Because of this, property taxes vary by location.

The fee paid to license a car is the property tax.

Sales Tax

Some states fund their state government programs with sales taxes. A **sales tax** is a tax on purchased goods and services. Most states charge a sales tax for purchases made in "brick and mortar" retail stores. However, some states are beginning to collect a sales tax for items purchased through an online retailer (Amazon, Gap, Barnes and Noble, etc.). Taxable goods and services vary by state and even by city and county. State and local governments have the ability to determine what goods and services are charged a sales tax. Some states charge a tax on all goods and services while others will exempt items such as food purchases. And, some states choose not to charge a sales tax because they fund state and local services from other types of taxes.

State and local governments determine the amount of sales tax charged. Sales tax is typically a percentage of your total purchase and is added to the original price of an item. For example, if you want to purchase a \$1.00 item in a state that has a 6% sales tax, you will pay \$1.06 for that item. The \$0.06 sales tax charge is added to the item at purchase, and the store owner passes the collected tax to the government.

Does your state have a sales tax? If so, do you know what items are taxed and at what percentage they are taxed?

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Excise Tax

Excise taxes are taxes collected from the seller or retailer and as such often remain “hidden” in the price of a product or service, rather than being listed separately. Items that are charged excise taxes vary depending on the state and local area, but may include:

- Gasoline
- Hotel rooms
- Alcohol
- Cigarettes
- Airline tickets

Depending upon the item, an excise tax may have a different label, such as a resort tax.

Excise tax is often included within the price of an item, such as gasoline. Some items may be charged both a sales tax and an excise tax.

Have you ever purchased an item that included an excise tax?

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Summary

Taxes are an important part of our society. Without them, we would have difficulty paying for many of the benefits enjoyed by being a member of a community. Taxes are charged in many different forms. The amount of taxes you pay and what you pay those taxes on varies depending upon your income and where you live. Taxes are created by representative bodies such as city councils, county commissioners, state legislatures, and members of Congress. Voters, who in most cases are also taxpayers, elect the representatives in these public positions. Therefore, individually you don't have a lot of control over taxes, but as a voting group, taxpayers are able to influence the tax policies set by elected public representatives.

What actions could you take as a taxpayer and voter to change the amount of taxes paid?

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Understanding taxes is an important part of money management. Taxes play a role in both earning and spending money. In addition, taxes can be a large component of your Spending Plan.
Make sure to consider taxes when managing your money.