



Understanding Taxes

by Sophia



WHAT'S COVERED

In this lesson, you will learn about the purpose and types of taxes. You will examine how you may need to make some changes in your spending to pay them. Specifically, this lesson will cover:

1. Overview of Taxes
2. Types of Taxes
 - 2a. Federal and State Income Taxes
 - 2b. Payroll Taxes
 - 2c. Sales Taxes
 - 2d. Property Taxes
3. Need for Taxes
4. Internal Revenue Service (IRS)

1. Overview of Taxes

If you have ever had a job, you know that **taxes** are simply a part of life. Taxes are financial obligations imposed on individuals and businesses by government entities. Governments use taxes to:

- Build infrastructure
- Provide social welfare
- Pay for national defense
- Provide other public services
- Encourage economic activity



BIG IDEA

Being knowledgeable about taxes will help you to plan your financial journey. To estimate your income accurately, you need to determine how much in taxes you will typically pay.

In this topic, we discuss the taxes that most individuals pay and how these taxes affect income.



Tax

A financial obligation imposed on individuals and businesses by government entities.

2. Types of Taxes

Most working adults will pay the following types of taxes:

- Federal income taxes
- State income taxes (where applicable)
- Payroll taxes
- Sales taxes
- Property taxes

↪ **EXAMPLE** Consider Amy. She is a part-time college student, has a part-time job, and owns a car. Let's see the types of taxes that Amy pays on a regular basis.

2a. Federal and State Income Taxes

Amy's job pays \$12 per hour. She works 20 hours a week and gets paid every other week (40 hours per pay period). She just picked up her first paycheck and is looking forward to depositing her \$480 of pay ($\12×40 hours of work).

- When Amy looked at her check, she was shocked to see that it was much less than the \$480 she was expecting.
- When she double-checked the pay stub accompanying her paycheck to verify that her hours were properly recorded, she then noticed all the **withholdings** from her **gross pay**. Gross pay is the total amount Amy earns before taxes and other deductions are considered.
- Withholdings are taken out of an employee's pay by the employer. Some withholdings are mandated by law, whereas other withholdings are elected by employees. Withholdings can include federal and state income taxes and payroll taxes, as well as employee benefits and charitable contributions.



KEY CONCEPT

Federal income tax withholdings are determined on **Form W-4**, which an employee fills out with her or his employer.

As shown in the following earnings statement, the total withholdings from Amy's paycheck were \$68.72. Her net pay (gross pay minus withholdings) was only \$411.28.

| Your Company Name | | Your Company Address | | EARNINGS STATEMENT | |
|-------------------|--------------------|----------------------|---------------|------------------------|---------|
| Amy Sample | | | # 0001 | | |
| SSN | PAY PERIOD | | PAY DATE | EMPLOYEE # | |
| xxx-xx-1234 | 1/1/2020-1/15/2020 | | 1/15/2020 | 120 | |
| INCOME | RATE | HOURS | CURRENT TOTAL | DEDUCTIONS | TOTAL |
| GROSS EARNINGS | 12 | 40 | 480 | FICA – MEDICARE | 6.96 |
| | | | | FICA – SOCIAL SECURITY | 29.76 |
| | | | | FEDERAL TAX | 17.00 |
| | | | | STATE TAX | 15.00 |
| YTD GROSS | YTD DEDUCTIONS | YTD NET PAY | | TOTAL | NET PAY |
| 480.00 | 68.72 | 411.28 | | 480.00 | 411.28 |

Amy's employer withheld federal and state income taxes based on her completed Form W-4. This form allows an employee to increase or decrease the amount of federal and state income taxes withheld each pay period, to better match his or her tax liability at the end of the year. In Amy's case, she did not claim any allowances on her W-4. Not claiming any allowances resulted in having more money withheld from her pay for income taxes.



HINT

You need to be aware of how much will be withheld for taxes because this will have a direct impact on your take-home pay and whether you will owe more taxes at the end of the year. You may need to use your **agility skill** to adjust your spending to ensure you can pay any amount due in April.



TERMS TO KNOW

Withholdings

Taken out of an employee's pay by the employer. Some withholdings are mandated by law, whereas other withholdings are elected by employees.

Gross Pay

Total amount of earnings before taxes and other deductions are considered.

2b. Payroll Taxes

Amy had a second type of tax taken from her pay, the **Federal Insurance Contributions Act (FICA)** tax, which is used exclusively to pay for two government programs:

1. Social Security (FICA Old Age, Survivor, and Disability Insurance). This applies to earned income up to \$128,400 (in 2018).
2. Medicare (FICA health insurance). This applies to all earned income.



HINT

As with federal and state taxes, FICA taxes will affect your take-home pay and therefore your net income. You need to make sure your budget and financial plans accurately reflect this impact on your earnings.



TERM TO KNOW

Federal Insurance Contributions Act (FICA)

Tax used exclusively to pay for Social Security and Medicare.

2c. Sales Taxes

During any given day, you are likely to pay another tax: **sales taxes**. Unlike payroll taxes, a sales tax is not deducted from your pay. Instead, sales taxes are imposed by state and local governments on the sale of certain goods and services. These taxes are paid when you buy something. Let's see how the sales tax affects Amy.

- After viewing her pay stub, Amy went out to lunch and ordered the \$6.95 special.
- The cashier told her that the total cost would be \$7.45.
- Amy realized that the extra 50 cents charged was sales tax.

Keep in mind that cities, counties, and states can all impose sales taxes. The amount of tax paid can differ dramatically from one location to another. A sales tax is determined based on two factors.

1. The **tax base** is the amount of money that will be taxed, which is generally based on the cost of the item you purchase.
2. The **tax rate** is used to calculate the amount of tax owed, which is generally denoted as a percentage rate, such as 7.5%.

The elements of the sales tax system are shown in the following formula.



FORMULA TO KNOW

Sales Tax

Multiply the tax base by the tax rate to determine the amount of tax you owe as a consumer.



⇒ **EXAMPLE** Say you stop by the store and purchase a new shirt for \$20.

- The shirt costs \$20. This is your tax base.
- Also assume that the combined state and local sales tax rate in your town is 7.5%. This is the tax rate.
- As shown in the calculation below, the sales tax that you will pay on your shirt is \$1.50, which is calculated by multiplying $\$20 \times 0.075$.
- Your total purchase price for the shirt is therefore \$21.50.

$$\text{\$20} \times 7.50\% = \text{\$1.50}$$



TERMS TO KNOW

Sales Tax

A tax that is imposed by state and local governments on the sale of certain goods and services.

Tax Base

The amount of money that will be taxed, which is generally based on the cost of the item you purchase.

Tax Rate

Used to calculate the amount of tax owed and is generally denoted as a percentage rate.

2d. Property Taxes

Let's catch up with Amy. After lunch, she had to renew her car registration at the local county motor vehicle registration office. After paying the fee to renew her car registration, she looked at the receipt and noticed that a significant portion of the fee was actually a **property tax**. A property tax is assessed based on the value of property that you own, such as your car or your home. Property taxes vary by state and are most often assessed by the city or county.

- Property taxes specifically imposed annually on the value of your vehicle are often referred to as ad valorem taxes, which means "according to value."
- The tax base for property taxes is the current assessed value of the property (which may be lower than the price you paid for the asset), as determined by the taxing authority.
- The tax rate is also determined by each taxing authority.
- Property tax rates for real estate vary significantly. In some locations, the property tax rate can be as high as 2.5%, while in other areas the rate is less than 0.5%!



TERM TO KNOW

Property Tax

A tax imposed by a local municipality or state, which is based on the value of the property.

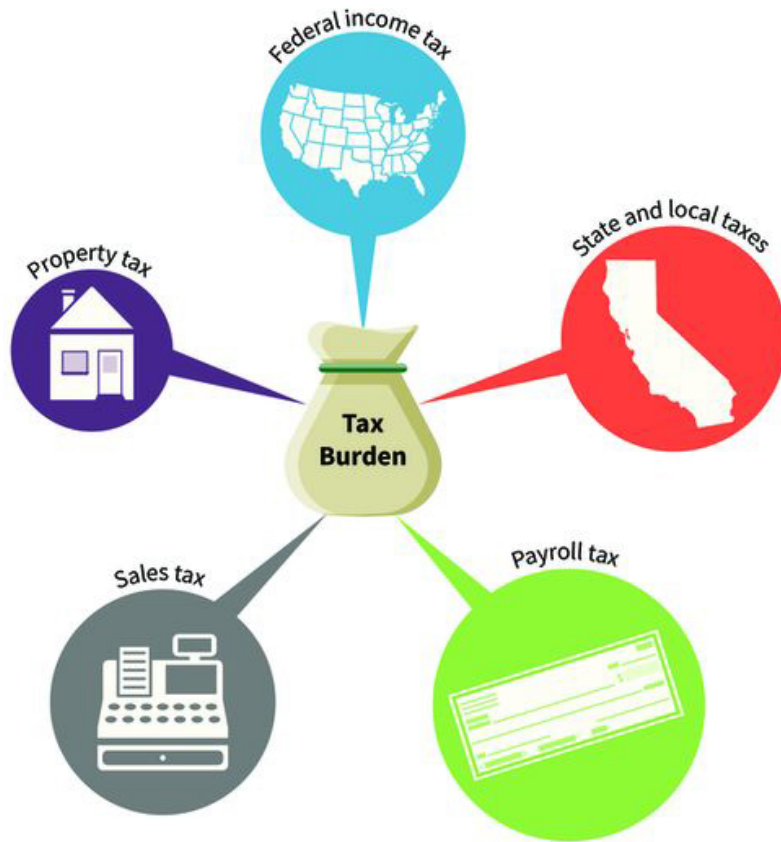
3. Need for Taxes

Considering her paycheck, lunch bill, and ad valorem tax on her car, Amy realized that she was paying a lot in taxes. These taxes, however, help to fund needed services in her community, such as the following:

- Her payroll taxes help to fund retirement benefits and health insurance for current retirees. Amy is also building credit in the Social Security system that can be used when she retires.

- The sales taxes paid help her local community pay for police and fire departments, schools, and public services.
- Her ad valorem taxes help to fund local roads, schools, and community improvements.

The illustration below shows the most common forms of tax that you are likely to encounter during your lifetime financial journey (the circle sizes are proportional to each tax's general impact on your financial situation).



4. Internal Revenue Service (IRS)

The **Internal Revenue Service (IRS)** is a government agency within the U.S. Department of the Treasury that is charged with collecting taxes and enforcing tax laws passed by Congress. (Congress, through the legislative process, actually creates the federal tax law.) In the United States, taxes are collected as money is earned, which is why state and federal taxes are withheld from each paycheck. If you are self-employed, you have the responsibility to pay your taxes on a quarterly basis (every 3 months) throughout the year.

Ultimately, the **IRS** can seek criminal action against individuals who commit fraud, which can result in prison time. Most penalties are a result of honest mistakes, but the taxpayer still must pay the penalty.



TERM TO KNOW

Internal Revenue Service (IRS)

A government agency within the U.S. Department of the Treasury that is charged with collecting taxes and enforcing tax laws passed by Congress.



SUMMARY

In this lesson, you looked at an **overview of taxes** and how you may need to be agile to meet your tax burden. You learned that the **Internal Revenue Service (IRS)** is the federal governing body that regulates taxes. The nation's **need for taxation** includes funding for maintaining roads and bridges, paying for military services, and providing public services such as education. There are several different **tax types**:

- **Federal and state income taxes** are taxes on your personal earnings.
- **Payroll taxes** are taxes set aside for government social welfare programs.
- **Sales taxes** are taxes on purchases you make for goods and services.
- **Property taxes** are taxes assessed on real estate that you own.

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