



Focus on  
**FINANCE**

## Income Tax: Facts and Filings



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### GLOSSARY

**Adjusted gross income:** Gross income minus specific adjustments.

**File (a tax return):** To mail or electronically transmit a taxpayer's income and tax liability information in a specified format.

**Gross income:** The total amount earned before any adjustments are subtracted.

**Income:** The payment people receive for providing resources in the marketplace. People also earn income in the form of rent, profit, and interest.

**Income tax:** Tax on income, both earned (salaries, wages, tips, commissions) and unearned (interest, dividends). Income taxes can be levied on both individuals (personal income taxes) and businesses (business and corporate income taxes).

**Revenue:** The income received by government from taxes and other nontax sources.

**Tax credit:** An amount directly deducted from the total tax owed.

**Tax deduction:** A fixed amount or percentage permitted by taxation authorities that a taxpayer could subtract from his or her gross income to reduce taxable income.

**Taxes:** Fees charged on business and individual income, activities, property, or products by governments. People are required to pay taxes.

**Tax exemption:** Amount allowed by the IRS that can be deducted from taxable income to reduce the amount of income tax owed. There are two types: personal and dependency. The personal exemption is for the taxpayer; the dependency exemption is based on the number of dependents the taxpayer has. The exemption amount is a set amount that changes from year to year.

"The hardest thing in the world to understand is the income tax."  
—Albert Einstein

### Introduction

It's on the calendar: the April 15th filing deadline for federal individual **income tax**. Just as a new year begins, it's tax-filing season and the frenzy begins. Some taxpayers are excited and eagerly anticipate a tax refund. Predictably, they are likely to **file** their tax returns early. Others are stressed and fearful of how much they might owe the government. Tax preparers are extremely busy filling out forms and filing tax returns. And on April 15th, some post offices stay open late to accommodate filers who wait until the last minute to make the midnight deadline. Why do tax forms cause such frenzy?

**Taxes** must be paid—it's the law. Federal individual income tax must be paid to the U.S. government on all forms of annual earnings that make up a taxpayer's taxable income. Taxable **income** is calculated based on the taxpayer's **adjusted gross income** for the tax year minus allowable **tax exemptions, deductions, and credits**. But making the calculations and completing the forms necessary for determining taxable income can be confusing and complex!

### 16th Amendment to the U.S. Constitution (1913)

The Congress shall have the power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration.

SOURCE: <http://www.ourdocuments.gov/doc.php?flash=true&doc=57>.

### History of the Federal Income Tax

Congress initiated the first U.S. federal income tax in 1862 to collect **revenue** for the expenses of the Civil War. The tax was eliminated in 1872. It made a short-lived comeback in 1894 but was ruled unconstitutional the very next year. Then, in 1913, the federal income tax resurfaced when the 16th Amendment to the Constitution gave Congress legal authority to tax

### 2016 Income Tax Brackets

The seven IRS tax brackets are 10%, 15%, 25%, 28%, 33%, 35%, and 39.6%. The amount of income tax owed depends on taxable income and filing status. Income falling within a particular bracket will be taxed at that tax rate. Additional income will be taxed according to the rate in the next tax bracket.

Example: The income tax a single taxpayer with a taxable income of \$10,000 must pay is 10% for the first \$9,275 plus 15% for the remaining \$725.

$$10\% \times \$9,275 = \$927.50$$

$$15\% \times \$725 = \$108.75$$

$$\text{Total Tax} = \$927.50 + \$108.75 = \$1,036.25$$

Rate	Filing Status			
	Single	Married filing separately	Married filing jointly or qualifying widow(er)	Head of household
10%	\$0 to \$9,275	\$0 to \$9,275	\$0 to \$18,550	\$0 to \$13,250
15%	\$9,276 to \$37,650	\$9,276 to \$37,650	\$18,551 to \$75,300	\$13,251 to \$50,400
25%	\$37,651 to \$91,150	\$37,651 to \$75,950	\$75,301 to \$151,900	\$50,401 to \$130,150
28%	\$91,151 to \$190,150	\$75,951 to \$115,725	\$151,901 to \$231,450	\$130,151 to \$210,800
33%	\$190,151 to \$413,350	\$115,726 to \$206,675	\$231,451 to \$413,350	\$210,801 to \$413,350
35%	\$413,351 to \$415,050	\$206,676 to \$233,475	\$413,351 to \$466,950	\$413,351 to \$441,000
39.6%	\$415,051 or more	\$233,476 or more	\$466,951 or more	\$441,001 or more

SOURCE: IRS; <https://www.irs.com/articles/2016-federal-tax-rates-personal-exemptions-and-standard-deductions>.

income. The result was a revenue law that taxed the income of both individuals and corporations.<sup>1</sup>

### Collection of the Federal Income Tax

Income tax is collected by the Internal Revenue Service (IRS), a federal agency. The IRS was originally called the Bureau of Internal Revenue, but the name changed in the 1950s.<sup>2</sup> Making the collection of the tax easier, the Current Tax Payment Act was signed into law in 1943.

This law requires employers to withhold federal income tax from an employee’s paycheck each pay period and send the payment directly to the IRS on behalf of the employee.<sup>3</sup> In this way, income tax is collected on a “pay as you earn” basis.

The amount withheld is determined by information the employee provides on an IRS W-4 form. This form collects information including the employee’s filing status, whether married or single, and allowances that can be claimed. The information is used to calculate a reasonable estimate of the amount of income tax to be withheld from each paycheck.

By January 31 of each year, employers must furnish employees a W-2 Wage and Tax Statement. This form is

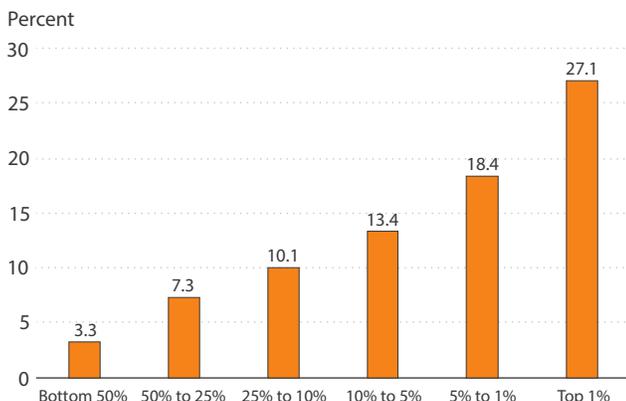
used by employees to complete individual tax returns. Among other things, it includes the total amount of income earned and the amount of federal income tax withheld over the given year. Generally, if too much federal income tax has been withheld, a taxpayer will receive a refund. If not enough has been withheld, the taxpayer must pay the government the additional amount owed.

### The Individual Income Tax Structure

The federal individual income tax is a progressive tax based on the ability-to-pay principle. A progressive tax is a tax in which higher-income earners pay a larger percentage of their income in tax than do lower-income earners. The IRS categorizes taxable income into tax brackets, and each tax bracket pays a different tax rate. To arrive at the tax rate, the taxpayer’s filing status must be determined as explained in Publication 501 from the IRS. After calculating the amount of taxable income and identifying the filing status, the tax rate can be identified. For example, for 2016, the seven tax brackets range from 10 to 39.6 percent. (See “2016 Income Tax Brackets.”)

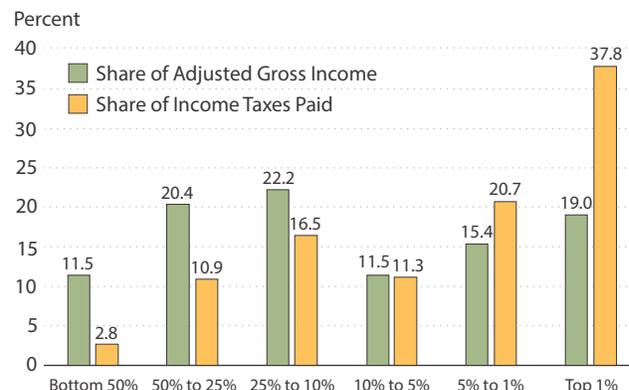
Without doubt, the highest income earners pay a greater portion of *total* income taxes collected by the IRS. For

**High-Income Taxpayers Pay the Highest Average Tax Rates**  
Average Income Tax Rate, by Income Group (2013)



NOTE: Original images ©Tax Foundation.  
SOURCE: IRS; <http://www.irs.gov/uac/SOI-Tax-Stats-Individual-Income-Tax-Rates-and-Tax-Shares>. Tax Foundation. "Summary of the Latest Federal Income Tax Data, 2015 Update." November 19, 2015; <http://taxfoundation.org/article/summary-latest-federal-income-tax-data-2015-update>.

**Half of Taxpayers Pay 97.2 Percent of All Income Taxes**  
Share of Income and Share of Income Taxes Paid, by Income Group (2013)



example, the top 50 percent of income earners paid 97.2 percent of all federal income taxes in the year 2013. (See the graphs.)

**The Purpose of the Federal Income Tax**

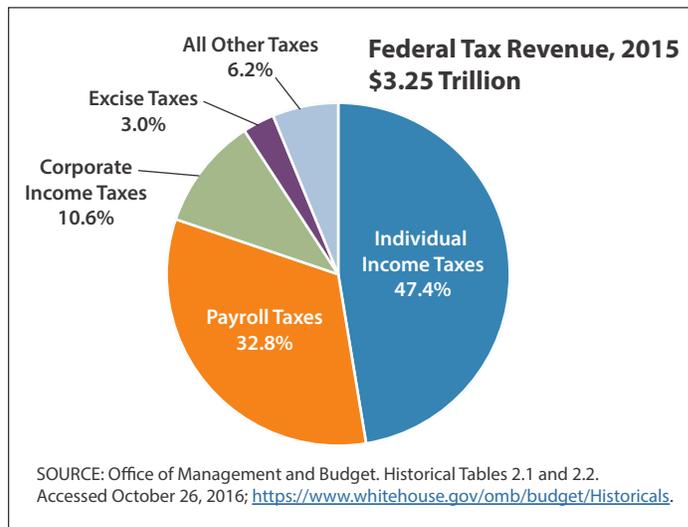
The U.S. government collects trillions of dollars in revenue from several types of taxes and fees. (See the pie chart.) Of all the federal taxes and fees, the individual income tax is the largest revenue source. For example, in 2015, it was \$1.54 trillion and nearly half of all tax revenue collected.<sup>4</sup> Congress and the president determine how this tax revenue is spent. The revenue allows the government to operate and provide goods and services for citizens, such as roads, bridges, national parks, education, research, and national defense.

**Tax Refunds**

A tax refund is money owed to a taxpayer when total tax payments or credits are greater than the total tax liability. On average, nearly four out of five U.S. tax filers get a tax refund from the government each year.<sup>5</sup> For the 2015 tax year, the IRS reports nearly 117 million individual income tax refunds, which totaled over \$346 billion.<sup>6</sup>

**Overpayment**

The majority of tax refunds are due to taxpayers having paid the government more than they actually owed in taxes. When a tax return is completed and an overpay-



ment is shown, the IRS refunds the overpayment. The government is not giving anything away—just returning money. Actually, since the government does not pay interest on an overpayment, the taxpayer is giving the government an interest-free loan out of each paycheck.

**Earned Income Tax Credit**

A second reason for tax refunds is the earned income tax credit (EITC). Of the nearly 117 million refunds for individual income tax in 2015, almost 24.1 million were based on the EITC.<sup>7</sup>

The EITC is a **tax credit** for low- to moderate-income working taxpayers, particularly those with children. The

### About the EITC

IRS Publication 596 is updated each year to assist taxpayers in determining the EITC allowed. Some of the general rules for 2015 are shown below.

#### Rules for Qualifying for the EITC in 2015

- You must have a valid Social Security number by the due date of your 2015 income tax return.
- Your filing status cannot be “married filing separately.”
- You must be a U.S. citizen or resident alien all year.
- You must have earned income.

Note: Your income must be less than the maximum amount given in the table. If you earn more, you do not qualify.

Number of qualifying children	Adjusted gross income for single taxpayers	Adjusted gross income for married filing jointly taxpayers
3 or more	Less than \$47,747	Less than \$53,267
2	Less than \$44,454	Less than \$49,974
1	Less than \$39,131	Less than \$44,651
0 (You must be at least age 25 but under age 65.)	Less than \$14,820	Less than \$20,330

SOURCE: IRS Publication 596.

amount of the EITC benefit depends on the recipient’s income and number of children. (See the “About the EITC” boxed insert.)

A tax credit directly reduces the amount of taxes owed. The EITC is different from most tax credits because it is a *refundable* tax credit. The credit can completely eliminate the income tax liability and result in a refund. For example, if a taxpayer has a tax liability of \$200 and an EITC of \$500, the taxpayer would be refunded the difference and receive a refund check in the amount of \$300.

### Federal Spending

The EITC began with the Tax Reduction Act of 1975, and this anti-poverty program has expanded over the years as determined by Congress.<sup>8</sup> The refundable portion of the EITC is classified as a spending program of the government and currently is the third-largest social welfare program in the United States. The largest two are Medicaid, a health care program for qualifying low-income individuals and those with disabilities, and

### 2013 Federal Spending on the Largest Anti-Poverty Programs

Program	Millions of dollars*
Medicaid	\$266,565
SNAP	\$82,603
EITC	\$55,123

NOTE: \*Inflation adjusted.

SOURCE: Office of Management and Budget; <https://www.whitehouse.gov/sites/default/files/omb/budget/fy2014/assets/hist.pdf>.

### Estimated EITC (billions of dollars)

Year	Total EITC	Refundable
2016	\$73.3	\$63.7
2017	\$76.0	\$66.1
2018	\$73.8	\$63.8
2019	\$75.6	\$65.3
<b>Total estimated</b>	<b>\$298.7</b>	<b>\$258.9</b>

SOURCE: The Joint Committee on Taxation. “Estimates of Federal Tax Expenditures for Fiscal Years 2015-2019.” December 7, 2015; <https://www.jct.gov/publications.html?func=startdown&id=4857>.

the Supplemental Nutrition Assistance Program (SNAP, formerly called food stamps), which helps low-income individuals purchase food.

The EITC is a benefit to taxpayers who receive it but directly reduces the amount of tax revenue for the U.S. government. In 2015, the refundable portion of the EITC was more than \$60 billion.<sup>9</sup> Looking forward, the Joint Committee on Taxation has estimated the cost of the EITC for each year through 2019. (See the table “Estimated EITC.”)

### Conclusion

The original income tax codes and regulations designed in 1862 took about 400 pages to describe. In 1913, the tax form was four pages and included one page of instructions.<sup>10</sup> Today, the federal tax code is almost 75,000 pages,<sup>11</sup> and the IRS website lists over 2,000 different forms and publications.<sup>12</sup> The increasing complexity causes many taxpayers to rely on professional tax preparers to complete and file their tax returns. In fact, a study of the 2011 tax year shows more than half of the

145 million individual tax returns were completed by a paid tax preparer.<sup>13</sup> With tax returns becoming longer and more complex and with more forms to file, the frenzy continues. ■

## Notes

<sup>1</sup> Library of Congress. "Today in History: Tax Day." Accessed October 17, 2016; <https://www.loc.gov/item/today-in-history/april-15#tax-day>.

<sup>2</sup> IRS. "Brief History of IRS." Accessed October 17, 2016; <https://www.irs.gov/uac/brief-history-of-irs>.

<sup>3</sup> Tax History.com. "Historical Perspectives on the Federal Income Tax." Accessed October 17, 2016; <http://www.taxhistory.com/1943.html>.

<sup>4</sup> Office of Management and Budget. Historical Tables 2.1 and 2.2. Accessed October 26, 2016; <https://www.whitehouse.gov/omb/budget/Historicals>.

<sup>5</sup> Sahadi, Jeanne. "Nearly 8 Out of 10 U.S. Taxpayers Get Refunds." CNN Money, January 14, 2015; <http://money.cnn.com/2015/01/13/pf/taxes/taxpayer-refunds/>.

<sup>6</sup> IRS. *Internal Revenue Service Data Book, 2015*. Publication 55B. Washington, DC: March 2016, pp. 17 and 19; <https://www.irs.gov/pub/irs-soi/15databk.pdf>.

<sup>7</sup> IRS. *Internal Revenue Service Data Book, 2015*. Publication 55B. Washington, DC: March 2016, p. 2; <https://www.irs.gov/pub/irs-soi/15databk.pdf>.

<sup>8</sup> Hungerford, Thomas L. and Thies, Rebecca. "The Earned Income Tax Credit and the Child Tax Credit: History, Purpose, Goals, and Effectiveness." Economic Policy Institute, September 25, 2013; <http://www.epi.org/publication/ib370-earned-income-tax-credit-and-the-child-tax-credit-history-purpose-goals-and-effectiveness/>.

<sup>9</sup> IRS. *Internal Revenue Service Data Book, 2015*. Publication 55B. Washington, DC: March 2016, p. 19; <https://www.irs.gov/pub/irs-soi/15databk.pdf>.

<sup>10</sup> Chamberlain, Andrew. "America's First Income Tax Form." Tax Foundation, July 7, 2005; <http://taxfoundation.org/blog/americas-first-income-tax-form>.

<sup>11</sup> Russell, Jason. "Look at How Many Pages Are in the Federal Tax Code." *Washington Examiner*, April 15, 2016; <http://www.washingtonexaminer.com/look-at-how-many-pages-are-in-the-federal-tax-code/article/2563032>.

<sup>12</sup> IRS. "Forms and Publications." Accessed October 19, 2016; <https://www.irs.gov/forms-pubs>.

<sup>13</sup> McTigue, James R. Jr. "Paid Tax Return Preparers: In a Limited Study, Preparers Made Significant Errors." GA0-14-467T. Washington DC: April 8, 2014; <http://www.gao.gov/assets/670/662356.pdf>.

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Federal Reserve Bank of St. Louis *Page One Economics*®:

**“Income Tax: Facts and Filings”**

After reading the article, complete the following:

1. For each question, write the title of the section(s) of the article that addresses the question and write a response. Cite information from the text that verifies your response.

Question	Response
a. From the first income tax until today, explain reasons why the government needs income tax revenue. What benefits are provided by income tax revenue?	
b. How is a refundable tax credit different from most tax credits?	
c. What gives the federal government the authority to collect income tax? What is the connection between the Current Tax Payment Act and the W-4 form?	
d. How do tax brackets affect the amount of income tax revenue collected?	
e. Why are tax refunds issued to taxpayers? What effect do income tax refunds have on the amount of federal tax revenue?	
f. How does a taxpayer’s number of children affect the adjusted gross income limits to qualify for the EITC?	

2. It's tax-filing season, and George has asked you to review his tax facts and estimate his tax liability for the year.

**George's Facts**

- **Adjusted gross income: \$52,500**
- **Taxable income: \$31,900 after allowable credits, deductions, and exemptions**
- **W-2: \$7,875 withheld for federal income tax**
- **Filing status: Married filing jointly**
- **Children: None**

- a. Does George qualify for the EITC? Explain your answer.
  
  
  
  
  
  
  
  
  
  
- b. Use the chart in "2016 Income Tax Brackets" to calculate the additional income tax George will owe or the refund he will receive.
  
  
  
  
  
  
  
  
  
  
- c. George expects his income and filing status to remain the same for the next tax year. Review the facts and the results of George's income tax liability for the year. What, if any, changes might you suggest George make on his W-4 form? Defend your decision.

3. It's tax-filing season, and Parker has asked you to help fill out his income tax forms and complete his tax return based on these facts:

**Parker's Facts**

- **Adjusted gross income: \$12,000**
- **Taxable income: \$1,700 after allowable credits, deductions, and exemptions**
- **W-2: \$500 withheld for federal income tax**
- **Filing status: Married filing jointly**
- **Children: None**

- a. Use the table in "2016 Income Tax Brackets" to calculate the additional income tax Parker will owe or the refund Parker will receive.

- b. When Parker's tax refund arrived, Parker was surprised that it was not \$330 but \$543! Use the chart in "About the EITC" to explain why Parker received a larger refund than expected.
  
4. The Current Tax Payment Act requires taxpayers to pay federal income tax each time they receive a paycheck. Explain advantages and disadvantages of this "pay as you earn" law. How is the law beneficial to the government?
  
5. You have a great job, and your taxable income puts you in the 35% income tax bracket. Explain how the ability-to-pay principle affects you.
  
6. The EITC can be described as a transfer of money from those who pay taxes to those who receive the benefits. Explain how this design affects income redistribution in the United States.
  
7. Explain the difference between a tax deduction and a tax credit.
  
8. In 1913, the income tax form was four pages and included one page of instructions. Go to <https://www.irs.gov/pub/irs-utl/1913.pdf> to view the original form. Work with a partner to analyze the form. Identify at least two facts from the form that you find interesting.