

Worksheet Solutions

Analyzing Specific Tax Situations

Theme 4: What Is Taxed and Why

Lesson 3: Income Tax Facts

Key Terms

exemptions—Amount that taxpayers can claim for themselves, their spouses, and eligible dependents. There are two types of exemptions—personal and dependency. Each exemption reduces the income subject to tax. The exemption amount is a set amount that changes from year to year.

horizontal equity—The concept that people in the same income group should be taxed at the same rate. “Equals should be taxed equally.”

tax credit—A dollar-for-dollar reduction in the tax. Can be deducted directly from taxes owed.

tax deduction—A part of a person’s or business’s expenses that reduces income subject to tax.

tax liability (or total tax bill)—The amount of tax that must be paid. Taxpayers meet (or pay) their federal income tax liability through withholding, estimated tax payments, and payments made with the tax forms they file with the government.

vertical equity—The concept that people in different income groups should pay different rates of taxes or different percentages of their incomes as taxes. “Unequals should be taxed unequally.”

withholding (“pay-as-you-earn” taxation)—Money, for example, that employers withhold from employees’ paychecks. This money is deposited for the government. (It will be credited against the employees’ tax liability when they file their returns.) Employers withhold money for federal income taxes, Social Security taxes, and state and local income taxes in some states and localities.

Summary

Income taxes are collected on a “pay-as-you-earn” basis. This system of **withholding** taxes from employees’ paychecks benefits the taxpayer and the government. Without withholding, many would find it difficult to save enough money to pay their taxes at the end of the year. Government services may be interrupted without continuous funding throughout the year. At year’s end, the amount withheld should roughly equal one’s **tax liability**.

Many believe that the U.S. tax structure should be based on the principles of **vertical equity** and **horizontal equity**. Vertical equity means that people in different income groups should pay different amounts or different percentages of their incomes as taxes. Horizontal equity means that people in the same income group should pay the same amount of taxes.

Even with the principles of vertical and horizontal equity, it is possible that two families or two businesses with identical incomes will pay different income taxes. **Tax deductions, exemptions, and tax credits** may lower tax liability. The government allows this special tax treatment to support or encourage behaviors, spending patterns, and lifestyles considered desirable.

Activity 1

Read each item below. Choose the reason that best explains the difference in tax liability. Write the letter of the correct answer in the space provided.

- A** 1. Nathan is single and earns \$52,000. He paid \$2,000 more in taxes than Mike and Ann. Mike and Ann have the same combined income as Nathan. Why did Nathan pay more than Mike and Ann?
A. Nathan is single.
B. Mike and Ann contributed \$25 to charity.
- B** 2. Two clothing stores sold the same amount of merchandise in a year. Store A paid taxes 50% higher than those paid by Store B. Why?
A. Store A is owned by a large corporation
B. Store B had more business expenses to claim as deductions.

Activity 2

Tax credits and deductions reflect the government's interest in supporting education, promoting the economy, and limiting government. Match the tax credit or deduction to the goal that it supports. Write the letter of the correct answer in the space provided.

Answer Key

- A. limiting government
- B. supporting education
- C. promoting the economy

- C** 1. child care credit
- A** 2. charitable contributions
- B** 3. education credits

Activity 3

Legislators are debating a change in the college tuition tax credit. Suppose that your family's income level is slightly above the amount needed to take advantage of this tax credit. How will this affect you and your family?

On a separate sheet of paper write a paragraph to express your opinion on the plan. Discuss the importance of balancing the government's three objectives—the need for government revenue, the need for fairness, and the desire to promote education.

Answers will vary but should reflect an understanding that all tax policy involves a compromise of competing goals.