

Taxes



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Taxes

If you are like many young Americans, when you got your very first paycheck at the burger joint, department store, or wherever you worked, you probably suffered a bit of tax shock as you saw a piece of your hard-earned money taken back by your employer. It's as though you were working for the IRS for an entire day or two each week. Indeed, if you were to satisfy your tax obligations first, starting on January 1, they wouldn't end until April if you were the average American.

Ever wonder what all those taxes out of your paycheck are for? You should. The government takes a certain percentage of your wages to fund various programs that Americans can take advantage of. On the federal level, Social Security, Medicare and federal unemployment taxes fund these programs, while the federal income tax funds a broader base of programs. In many—but not all—states, unemployment and income taxes fund payments of unemployment insurance and many state programs. Locally, local income taxes support the cities and counties you live and work in. These taxes are paid on a certain percentage of your income and are automatically taken out of your paycheck by your employer. While you do have some say in how much income tax is taken out of your check, you have no say in how much Medicare, Social Security and unemployment taxes are withheld.

Let's take a look at taxes in more depth.

Payroll Taxes: Social Security and Medicare

Social Security and Medicare taxes (also referred to as FICA taxes)

Federal Insurance Contributions Act (FICA) tax is a United States federal payroll tax imposed on both employees and employers to fund Social Security and Medicare—federal programs that provide benefits for retirees, the disabled, and children of deceased workers.

Both you and your employer pay Social Security taxes on your wages.

FICA taxes are taken out of your paycheck at a tax rate of 6.2 percent each for employers and employees for Social Security, and 1.45 percent each for Medicare. That means both the employer and employee pay Social Security taxes at these rates on the first \$118,500 of the employee's wages in 2016. Once that limit is reached, no more taxes are withheld for Social Security for the rest of the calendar year. There is no limit to the amount of wages to which the Medicare tax applies. Withholding of these taxes is resumed at the beginning of the new calendar year. The withholding limit is tied to inflation, so it usually increases each year.

SOCIAL SECURITY TAXES

Employer and Employee
6.2% on wages up to: \$118,500

MEDICARE TAXES

Employer and Employee
1.45% on all wages earned

What is Social Security?

Social Security is a federal retirement and disability income program. Based on how much a person has earned during their lifetime, they receive benefits once they retire or if they become disabled. The earliest permissible age to receive Social Security benefits for retirement is currently 62. If they wait until age 65 to 70 to receive benefits, their monthly benefit is larger than if they started taking benefits at age 62. The benefits received do not equal what a person contributed into the system, as retired workers generally end up getting more in benefits than they contributed. Medicare taxes pay for the Medicare health care program, which provides health care coverage for all US citizens over the age of 65. Coverage includes hospitalization, care by physicians, and some drug and medical equipment benefits.

Question 1:

Only employees pay Social Security taxes on their earnings.

- True
- **False**

ANSWER: False. Employers pay the same amount on behalf of their employees, according to how much the employees pay.

Question 2:

Social Security is a federal _____.

- Health insurance program
- Retirement income program
- Disability income program
- **Retirement and disability income program, but not a health insurance program**

ANSWER: Retirement and disability income program, but not a health insurance program. Medicare is a health insurance program, but Social Security is not.

Question 3:

Everyone will have to pay Social Security tax on all their income, no matter how much it is.

- True
- **False**

ANSWER: False. The amount of earnings one must pay tax on is capped, though it usually changes every year.

Federal and State Income Taxes

Federal, state, and local income taxes; federal and state unemployment taxes; and Medicare and Social Security taxes are called payroll taxes. They are automatically taken out of your paycheck every time you are paid, based on a flat, fixed tax rate for state and local income taxes and Medicare and Social Security taxes. For federal income taxes, the rate depends on your tax filing status and the number of withholding allowances you choose when you fill out federal tax withholding forms like the W-4.

Federal and state taxes

The federal tax rate you pay will vary depending on your filing status. The various statuses include married filing jointly, qualifying widow or widower, head of household (if you have one or more qualified dependents living with you during the tax year), single, and married filing separately. Your tax forms will explain what each of these mean.

Getting started with the W-4

Every year, you fill out a federal Form W-4 withholding form, which is provided by your employer. On that form, you state your filing status and the number of withholding allowances you wish to claim. Your filing determines which tax bracket you fall in and is based on whether you are single, married, head of household, or a surviving spouse. Withholding allowances are the personal exemptions you are allowed to take based on the number of people and dependents residing with you. For example, if you are married and have two children, you would generally fill out your W-4 form with four exemptions, since that is what you are entitled to take under IRS law (you get to include yourself as an exemption). The more exemptions you have, the less federal and state income tax is withheld from your paycheck. Your employer uses your W-4 form to determine what percentage of federal and state income taxes to withhold from your paycheck.

State and local taxes

For both local and state income taxes, you pay tax based on the state and locality where you work, rather than where you live. States that levy an income tax generally set a flat rate based on the amount of income you earn, as do local governments that levy an income tax.

Question 1:

There is one federal income tax rate that all taxpayers pay.

- True
- **False**

ANSWER: False. As you earn more money, your rate increases.

Question 2:

The various income tax filing statuses include _____.

- Married filing separately
- Head of household
- Single
- **All of the above**

ANSWER: All of the above. There are several statuses that determine your rate.

Question 3:

The W-4 federal tax form is used by _____.

- **Taxpayers to set their tax withholding schedule**
- Employers to pay withholding taxes to the government
- All of the above
- None of the above

ANSWER: Taxpayers to set their tax withholding schedule. You fill out this form when you start a job.

Ways to Lower Your Income Taxes

Income taxes on the federal level are a fact of life for everyone, and many people also have to pay state and local taxes. When you make an effort to plan around taxes, you can save yourself money that you would otherwise pay to the federal, state, or local governments. While you may not notice the impact of federal taxes because they are being taken out of your paycheck, they are the biggest expense that most families incur in the course of a year.

When you save more for retirement, you may pay less in taxes.

There are many ways you can lower your taxes

Many retirement plans shelter your money from taxes. They are *tax-deferred*, in other words. *Tax-deferred* means that the earnings that build up in your retirement plan are not taxed, as long as they stay in there. However, once you draw them out, either at retirement or before, your earnings from these plans may be taxed.

Here are some of the methods that can pay off in the biggest ways:

- **Retirement contributions:** Contributing to a retirement plan is one of the best ways you can save for your own future and save money on taxes. When you contribute to a traditional 401(k) plan at work, those contributions reduce your income, so you will owe less tax. When you contribute to a traditional individual retirement account (IRA), you also reduce your taxable income, as you will record how much you contributed on your tax form, and that will be subtracted from your income. With a Roth IRA or a Roth 401(k), however, you cannot take such a deduction.
- **Flexible spending account contributions:** When you make contributions to a flexible spending account at work, the contributions are taken out of your pay, meaning there is less income for you to be taxed on. Flexible spending accounts help pay for certain expenses, such as medical costs.
- **Health savings account contributions:** If you have a health savings account, you can deduct the contributions you make to it from your income, which means less income for you to be taxed on. This also helps you save for healthcare expenses.
- **Charitable donations:** If you donate money to a church, social services organization or non-profit, you may be able to deduct that money from your income on your tax return. It's important to document what you donate, which you can do either by writing a check or obtaining a receipt from the charitable organization.
- **Student loan interest paid:** Interest is tax-deductible.
- **Moving:** If you move to a new home because of a new job, you may be able to deduct your moving expenses. But you must meet certain tests.
- **Tuition and fees:** Education expenses that qualify can be deducted from your income on your tax return, thus reducing the amount of tax you must pay. Generally, qualified education expenses are amounts paid for tuition and fees.

Question 1:

When you take time to engage in tax planning, you can save yourself money you would otherwise pay to the government in taxes.

- True
- False

ANSWER: True. When you take the time to engage in tax planning, you can save yourself money you would otherwise pay to the government in taxes.

Question 2:

What kind of retirement planning contributions can help you save money on filing your taxes currently?

- A health savings account
- A traditional IRA
- A Roth 401(k)

ANSWER: A traditional IRA. Contributions to a traditional IRA can help you save money on filing your taxes currently. Roth 401(k)s cannot, and health savings accounts are not retirement plans.

Question 3:

A _____ is one kind of contribution that can help save you money on your taxes.

- **Flexible spending account**
- Tax-free account
- Cafeteria plan

ANSWER: Flexible spending account. A flexible spending account is one kind of contribution you can make that can help save you money on your taxes.

Your Tax Return

The federal and state governments collect taxes to pay their bills and provide public goods and services. Our tax collection agency in the United States is the Internal Revenue Service (IRS). Taxes are collected by the IRS from individuals throughout the year through tax withholding from each paycheck.

Filing a tax return means determining whether you have paid the correct amount of tax through withholdings from your paycheck.

You need to organize your tax information every year to make filing your tax return easy.

U.S. citizens and residents who have gross income beyond a specified amount are required by law to file federal income tax returns. Filing a tax return is the equivalent of completing an income tax self-assessment. It is simply the process of determining if you have paid the correct amount of income tax for the year based on your taxable income. The taxes withheld from your pay are estimates. When you file a tax return you and the IRS are in essence "settling up." You will owe them money if you under paid or they may owe you money if you overpaid throughout the year.

This settling up process is required for most individuals each year and is completed by filling out the appropriate tax return form for the federal and state government. A tax return form is a report filed with the IRS or your state government (if applicable) containing income and other important information necessary to calculate the actual tax you should pay for the year. This actual tax owed is compared to what you had withheld; the difference will result in a refund if you overpaid or an amount you owe if you underpaid.

The standard U.S. individual tax return is Form 1040. There are several variations of this form, such as the 1040EZ and the 1040A, as well as many supplemental forms. All of the income information required to be reported on your tax forms will be sent to you by your various employers and financial institutions. We will discuss this further below.

Organizing your tax information

Whether you prepare your taxes yourself or use a tax preparation service or an accountant, you still need to organize your tax information. If you take your time and approach it in an organized way, it doesn't have to be overwhelming or even take a lot of time. For example, you could keep it in an electronic or physical folder and add to it as you approach tax time. Employers and most others must send you tax information by January 31.

Personal information

Start with the personal information you will need, which includes your Social Security number and that of your spouse and dependents, if you have any. You'll need last year's tax return and your checking account and bank routing number, in case you'll get a refund and want to have that directly deposited into your bank account.

Taxable income

To determine your income for tax purposes, you need your W-2 from your employer and any 1099s you may receive reporting income from side businesses or self-employment income you earned. If you receive alimony or unemployment benefits or get Social Security, you will also need those statements.

Here are some other types of income and adjustments to income that you may have:

- Investment or interest income from a bank, credit union, or other financial institution
- Income from jury duty, scholarships earned, or gambling winnings
- IRA or other retirement plan distributions
- Income from sale of a home or rental property
- Cancellation of certain debts

Tax withholding

When you complete a W-4 form for your employer, you are providing them with information that will determine how much of your income will be withheld and paid to the federal and state government every paycheck. The taxes withheld are only an estimate of what you owe in taxes.

Every year, you will complete a federal and state tax return to determine if you overpaid or underpaid your taxes.

- If you overpaid, you will get a tax refund. Remember, this is your own money the government is giving back to you.
- If you underpaid, you will be required to pay the difference to the government when you file your taxes.

If you find that what you are having withheld in taxes is significantly over- or understated, you should complete a new W-4 and request that more or less in taxes be withheld.

Review this sample W-2 to learn more about your income and taxes withheld. This document is necessary to complete your tax return(s).

You will compare the tax you had withheld during the year to what your tax return (complete form 1040EZ) indicates you should have paid. If your tax return says you owe less than the amount you paid in, you will get a refund! If you owe more, you will need to pay the federal government (IRS) what you owe them.

22222	Void <input type="checkbox"/>	a Employee's social security number 111-22-3333		1 Wages, tips, other compensation 20000	2 Federal income tax withheld 1200
b Employer identification number (EIN)				3 Social security wages 20000	4 Social security tax withheld 1240
c Employer's name, address, and ZIP code				5 Medicare wages and tips 20000	6 Medicare tax withheld 290
				7 Social security tips	
				8 Medicare tips	
d Control number				9	10
e Employee's first name and initial		Last name		Suff.	
f Employee's address and ZIP code				11 Nonqualified plans	
				12a See instructions	
				12b	
				12c	
13				12d	
14 Other				15	
15 State				16 State wages, tips, etc. 20000	17 State income tax 400
Employer's state ID number				18 Local wages, tips, etc.	19 Local income tax
20 Locality name					

You will compare the tax you had withheld during the year to what your STATE tax return indicates you should have paid. If you return say you owe less than the amount you paid in, you will get a refund. If you owe more, you will need to pay the state what you owe them.

> 6.20% of every dollar you make goes to social security taxes. This is not refundable.

> 1.45% of every dollar you make goes to medicare taxes. This is not refundable.

Form **W-2** Wage and Tax Statement

Copy A For Social Security Administration — Send this entire page with Form W-3 to the Social Security Administration; photocopies are not acceptable.

Department of the Treasury — Internal Revenue Service
 For Privacy Act and Paperwork Reduction Act Notice, see the separate instructions.
 Cat. No. 10134D

Do Not Cut, Fold, or Staple Forms on This Page

For completing their federal taxes, many younger taxpayers use the 1040EZ form. [Click here for an instructional outline of the 1040EZ form.](#) [PDF]

Question 1:

Personal information you will need to prepare your tax return includes _____.

- Your former address
- **Your Social Security number**
- Your parents' names

ANSWER: Your Social Security number. Personal information you will need to prepare your tax return includes your Social Security number.

Question 2:

Everyone must prepare a state income tax return.

- True
- **False**

ANSWER: False. If you live in a state that has a personal income tax, you must prepare a state income tax return. But not all states have that tax. Also, people living on land held in trust by the federal government may be exempt from state taxes.

Question 3:

Having taxes withheld from your paycheck means you do not need to pay any more taxes.

- True
- False
- **Maybe**

ANSWER: Maybe. The taxes that are withheld from your paycheck are estimates of how much tax you must pay. Once you have filled out your tax return and determined the actual amount you owe, you will find that you owe more money or that you will get some money back.

Exemptions, Deductions, Adjustments, and Credits on Your Income Tax Form

Personal exemptions

"Personal exemptions" from income are tax deductions for members of your family. They are based on the number of people and dependents living with you. You declare them on your W-4 form, and you also declare them on your tax form. They will lower your tax burden. The more exemptions you have, the less federal and state income tax is withheld from your paycheck.

Take advantage of the deductions and credits available to you.

Take the higher of your standard deduction or your itemized deductions.

Deductions, adjustments and credits

The government offers a wide variety of deductions, adjustments, and credits to lower the amount of income on which you must pay taxes. These are good to have. If you have enough deductions and credits, you can itemize, which involves listing specific information on Schedule A; if not, you can take the standard deduction. The standard deduction is a pre-set amount that reduces the amount that you have to pay in tax; you do not need to gather and list the various deductions if you go this route. For most people, the standard deduction is not only easier to take but also saves more money.

The only way to determine which course makes sense is to gather all the information and do the calculations yourself through tax preparation software or give it to your tax preparer to determine.

There are also deductions and credits that don't depend on whether you itemize or not. These are called adjustments. Contributions to IRAs are an example of these.

Deductions and credits, and the difference between the two

Another tax-planning approach is to reduce the part of your income that is subject to tax by taking full advantage of the many tax deductions and tax credits available to both businesses and individuals. Talking with a tax-planning professional is the best way to learn which deductions and credits are available to you. The small business owner, for example, may be able to deduct the cost of meals and entertainment, automobile expenses, and business travel, among many other costs. But there are always special rules that apply to these deductions, so again, the services of a tax professional can be invaluable.

For the moment, keep in mind the difference between a tax deduction and a tax credit. A tax deduction reduces the amount of taxable income you have. A credit reduces the actual tax you owe, within limits, usually dollar for dollar (for example, a one-dollar tax credit reduces your tax bill by one dollar). Sometimes, tax credits are refundable, which means you can, in some cases, get a check from the government if you owe no tax at all. Clearly, tax credits are more valuable than deductions.

Here is a simplified example. Imagine you earned \$20,000 last year and your tax rate was 10%. Normally, that would mean you pay \$2,000 in taxes ($\$20,000 \times 10\%$). A \$1000 tax deduction would reduce your income to \$19,000. Therefore, you would owe \$1,900 in taxes. But a \$1000 tax credit would instead reduce your \$2000 tax burden to only \$1000. Credits, as you can see, save you much more money.

Question 1:

Which of the following is true regarding tax credits?

- A tax credit reduces your taxable income as reported on Form 1040.
- **A tax credit reduces the actual tax you owe.**
- For most taxpayers, the standard tax credit will be larger and more valuable than itemizing your credits.

ANSWER: A tax credit reduces the actual tax you owe. Within limits, a dollar of credit reduces your tax by a dollar.

Question 2:

The difference between a tax deduction and a tax credit is that _____.

- **A tax deduction reduces your taxable income, and a tax credit reduces your actual tax**
- A tax deduction reduces your actual tax, and a tax credit reduces your taxable income
- A tax deduction always gets you more money at tax time
- None of the above

ANSWER: A tax deduction reduces your taxable income, and a tax credit reduces your actual tax. When you do the math, you will find that tax credits get you more money back than tax deductions do.

Question 3:

Tax exemptions, adjustments, deductions and credits all have one thing in common. What is that?

- Everyone gets them.
- You have to work for someone else to get them.
- **They reduce the amount of tax you have to pay.**
- None of the above

ANSWER: They reduce the amount of tax you have to pay. Exemptions, adjustments, deductions and credits all reduce the amount of tax you have to pay. They all do this in different ways.

Tax Simulation Activity

Okay. It's time to put what you've learned into practice. In this activity, you assume the profile of a young adult (age 22) who recently received their W-2 statement from their employer. It's time to complete your tax return to determine if you withheld too much or too little in federal taxes last year. Does the IRS owe you a refund or do you owe the IRS additional taxes?

You work for Action Outdoors and have received the W-2 statement below detailing your income, Social Security and Medicare tax withheld from your pay, and your federal income tax withheld and sent to the IRS for 2015.

Use the information on the W-2 to complete the tax return at the link provided below. Assume you are single with no dependents, and that you are not a dependent of anyone else.

22222		a Employee's social security number 123-45-6789		OMB No. 1545-0008	
b Employer identification number (EIN)			1 Wages, tips, other compensation 34000		2 Federal income tax withheld 2800
c Employer's name, address, and ZIP code Action Outdoors 100 Big Buck Lane Black River Falls, WI 55555			3 Social security wages 34000		4 Social security tax withheld 2108
			5 Medicare wages and tips 34000		6 Medicare tax withheld 493
			7 Social security tips		8 Allocated tips
d Control number			9		10 Dependent care benefits
e Employee's first name and initial Jane L.		Last name Sample	Suff.	11 Nonqualified plans	
f Employee's address and ZIP code 123 Oak Street Black River Falls, WI 55555			13 Statutory employee <input type="checkbox"/> Retirement plan <input type="checkbox"/> Third-party sick pay <input type="checkbox"/>		12a
			14 Other		12b
					12c
					12d
15 State Employer's state ID number	16 State wages, tips, etc. 34000	17 State income tax 0	18 Local wages, tips, etc.	19 Local income tax	20 Locality name

[Click this link to complete your 1040EZ tax form.](#) [PDF]

[Click on this link to get the 1040EZ tax tables.](#) [PDF]

After completing your 1040EZ tax form, [click on this link to check your work.](#) [PDF]

Summary of Taxes

You should now have a better sense of what you're getting for all those hours you put into your taxes. Taxes are a fact of life for most people. Employees must pay a variety of taxes that are deducted from their paychecks, which include federal, state, and local income taxes and Medicare and Social Security taxes. Employers must match employee payments for Medicare and Social Security and also pay federal and state unemployment taxes.

The amount of federal, state, and local payroll tax you must pay depends on several factors, including your filing status and your tax rate. Medicare and Social Security tax rates, however, are fixed and help support programs that provide for retired and disabled people.