

11.2: INCOME TAXES

THE HISTORY OF INCOME TAX LAW: The original founders of the U.S. Constitution authorized the newly formed federal government to collect taxes. Article I, Section 8, Clause 1 of the U.S. Constitution states:

The Congress shall have Power to lay and collect Taxes, Duties, Imposts and Excises, to pay the Debts and provide for the common Defence and general Welfare of the United States; but all Duties, Imposts and Excises shall be uniform throughout the United States.

Article I, Section 9, Clause 4 of the U.S. Constitution states:

No Capitation, or other direct, Tax shall be laid, unless in proportion to the Census or Enumeration herein before directed to be taken.

However, this authorization to collect taxes in the original Constitution has several restrictions. It required taxes to be uniform throughout the country. The Constitution also states no “Capitation, or other tax” meaning a poll tax or head count tax, could be imposed unless it proportional to the population of the state. Income taxes would not fall into this category. In 1913, the Sixteenth Amendment to the U.S. Constitution was ratified which authorizes the collection of taxes based on income by the federal government.

The Congress shall have 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.

In 1919, NYS also imposed a state income tax. In addition to the state income tax, Manhattan and Yonkers eventually passed a city income tax. There are a few states, like Texas and Florida that do not have a state income tax.

GRADUATED TAX BRACKET SYSTEM: NYS and the Federal government both calculate the amount of income taxes paid by taxpayers using what is called a graduated tax bracket system. (This is sometimes referred to as a progressive tax system.) This means taxpayers pay a certain percentage of their income in taxes based on the amount of income they earn each year. Various income tax brackets are created based on income ranges. The rate or percentage the taxpayers pay in taxes is different for each income tax bracket. This is in contrast to a flat tax system which has all taxpayers pay the same percentage in taxes regardless of their income. Generally, this means that taxpayers with higher taxable incomes pay their taxes at a higher percentage rate, and taxpayers with lower taxable incomes pay their taxes at a lower percentage rate. Below are the 2018 federal income tax brackets and rates associated with each.

Federal Income Tax Brackets and Rates for 2018*

Rate	For Unmarried Individuals, Taxable Income Over	For Married Individuals Filing Joint Returns, Taxable Income Over	For Heads of Households, Taxable Income Over
10%	\$0	\$0	\$0
12%	\$9,525	\$19,050	\$13,600
22%	\$38,700	\$77,400	\$51,800
24%	\$82,500	\$165,000	\$82,500
32%	\$157,500	\$315,000	\$157,500
35%	\$200,000	\$400,000	\$200,000
37%	\$500,000	\$600,000	\$500,000

*Source Tax Foundation 2018 Tax Brackets by Amir El-Sibaie, January 2, 2018
(<https://taxfoundation.org/2018-tax-brackets/>)

A review of the above chart demonstrates how the graduated tax bracket system works. There are seven tax brackets starting with incomes up to \$9,525 for a single filer, up to \$500,000 for a single filer. The tax rates or percentages start at 10% for the lowest tax bracket up to 37% for the highest tax bracket.

Graduated income tax brackets are deemed to be fairer than a flat tax system because lower income individuals and families typically need more of their income to sustain them. As income increases, less of that income is used for the basic necessities like food, clothing, and housing. Increased income also increases what is referred to as disposable income.

The Merriam-Webster dictionary defines disposable income as, "Income that is left after paying taxes and for things that are essential, such as food and housing." (Merriam-Webster.com. 2018. <https://www.merriam-webster.com> (20 July 2018) The current tax code is designed to have those with more disposable income carry the higher burden of income taxes because they can afford to do so. Almost half of the tax payers pay no federal income tax, but they still do pay a significant amount in taxes nevertheless. An article published on April 18, 2018 by Market Watch titled "46% of Americans pay no federal income tax-here's why" by Quentin Fottrell confirms the data pointing out that, "All but the top 20% of American families pay more in payroll taxes than in federal income taxes, according to Treasury Department data, cited by the Pew Research Center."

(<https://www.marketwatch.com/story/81-million-americans-wont-pay-any-federal-income-taxes-this-year-heres-why-2018-04-16>)

INCOME TAX PAYMENT PROCESS: The general income tax payment process for a typical taxpayer that is an employee receiving a paycheck from their employer is as follows:

- Upon hire, employee fills out a W-4.
- Employee works for the employer and receives compensation in the form of a paycheck.
- Employer makes withholdings from the taxpayer's paycheck for taxes and FICA based on the W-4 and sends those withholdings to the state and federal income tax agencies.
- After the end of the year, employer sends the taxpayer and the state and federal income tax agencies, the employee's W-2.
- The employee determines their gross income from the W-2 form to fill out their state and federal income tax returns.
- The employee determines their filing status to fill out their state and federal income tax returns.
- The employee determines their withholdings using their W-2 and uses that information to fill out their state and federal tax returns.
- The employee determines their deductions and tax credits to calculate their taxable income and income tax liability.
- The employee signs and files their state and federal tax returns with the respective income tax agencies.

FILING STATUS: A review of the tax brackets chart above indicates three different tax filing statuses; unmarried individuals, married individuals filing joint returns, and heads of households. Not mentioned above is married filing separately. Filing status affects tax rates. Married couples have a choice on how to file, which is usually by their respective incomes. Below is a brief summary of 4 of the most common filing statuses.

1. An unmarried individual is a taxpayer who is single.
2. Married filing joint is for married taxpayers who are filing their taxes together.
3. Married filing separately is for married taxpayers who choose to file separate income tax returns.
4. Head of Household is for individuals who:
 1. file separately;
 2. are unmarried, or are considered to be unmarried by living apart from their spouse for at last six months of the tax year;
 3. provided more than 50% of household support for the main home in which the taxpayer lived during the tax year;
 4. supported at least one qualifying dependent child during the tax year.

STANDARD DEDUCTION, ITEMIZED DEDUCTIONS, TAX CREDITS, & TAXABLE INCOME: The amount one pays in income taxes is not totally based on a taxpayer's income alone. The standard deduction or itemized deductions play an important role in the income tax system. They are used to determine what a taxpayer's taxable income will be. That, in turn, determines what tax bracket a taxpayer will be in and that in turn determines what tax rate the taxpayer will pay. (Before the new Tax Cuts and Jobs

Act of 2017 law was passed, there were also personal and dependent exemptions allowed. Those were eliminated in 2018.) Deductions are allowed under the tax code for certain expenses that taxpayers incur in that tax year.

The tax code is often used to encourage certain behaviors like buying a home or purchasing an electric automobile. To incentivize taxpayers to do certain things, deductions and tax credits are made available which lower the taxable income of taxpayers and thereby lower their income taxes.

Taxpayers have a choice of using the standard deduction which is the same for all taxpayers based on their filing status or itemizing their deductions. Whether a taxpayer itemizes or uses the standard deduction is a calculation the taxpayer has to make to determine which is more advantageous for them. Higher income earners tend to find that itemizing their deductions is more advantageous than using the standard deduction while the opposite tends to be true for lower tax earners.

The 2018 standard deduction for taxpayers is as follows:

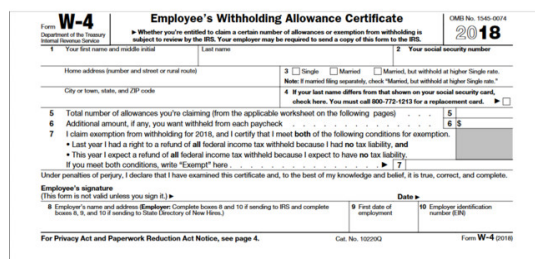
- Single or married filing separately: \$12,000
- Married filing jointly: \$24,000
- Head of household: \$18,000

Deductions are different than tax credits. Deductions are used to determine what the taxable income. For example, if a single taxpayer earns \$50,000 and takes the standard deduction of \$12,000, that taxpayer's taxable income is \$38,000. The tax rate for \$38,000 is 12% versus the tax rate for \$50,000 which is 22%. The very basic math calculation is the taxpayer will owe \$4,560 in federal income taxes. Now, if a taxpayer also has a tax credit, that credit will be applied to the actual tax amount owed. Taking our above example, if this taxpayer also has a dependent child that the taxpayer cares for and supports, there is a \$2,000 tax credit allowed. The taxpayer will now pay \$2,560 in federal taxes after taking the tax credit.

Some of the deductions available are for mortgage interest, student loan interest, and medical insurance. Some of the tax credits available are for dependent children, college education, earned income credit, (for low income earners with dependent children) and child care.

W-4 FORM: The W-4 form is used by an employer to determine how much they will withhold from an employee's paycheck. Withholding refers to the amount of money an employer holds as prepayment of income taxes and FICA contributions from an employee's paycheck and sends to the New York State Department of Taxation and Finance and the Internal Revenue Service on behalf of the employee. To make this determination, all employees fill out a W-4 form with their employers. The information the employee provides on the form provides the employer with the correct information to determine how much the employer should withhold from the employee's paycheck for income tax purposes.

The W-4 form gives an employee the opportunity to choose how the number of allowances they want to claim. Allowances are the anticipated deductions and/or credits the employee anticipates they will claim on when they file their federal and state income tax forms. The more allowances a taxpayer claims, the less the employer will withhold for taxes from the employee's paycheck. This can result in more or less money in the taxpayer's paycheck, but it can also determine how much of a refund or taxes the taxpayer may own when they file.



W-4 Employee's Withholding Allowance Certificate (OMB No. 1545-0047) **2018**

Form W-4 (2018) Department of the Treasury Internal Revenue Service

1 Your first name and middle initial Last name 2 Your social security number

3 Home address (number and street or rural route) City or town, state, and ZIP code

4 ☐ Single ☐ Married ☐ Married, but withheld at higher single rate. Note: If married filing separately, check "Married, but withheld at higher single rate." 5 If your last name differs from that shown on your social security card, check here. You must call 800-772-1213 for a replacement card. ☐

6 Total number of allowances you're claiming (from the applicable worksheet on the following pages) 7 Additional amount, if any, you want withheld from each paycheck

8 I claim exemption from withholding for 2018, and I certify that I meet both of the following conditions for exemption. Last year I had a right to a refund of all federal income tax withheld because I had no tax liability, and This year I expect a refund of all federal income tax withheld because I expect to have no tax liability. If you meet both conditions, write "Exempt" here. 9 Under penalties of perjury, I declare that I have examined this certificate and, to the best of my knowledge and belief, it is true, correct, and complete.

Employer's signature (This form is not valid unless you sign it.) 10 Date 11 Employer's name and address (Employer completes boxes 10 and 11 if sending to IRS and complete boxes 6, 9, and 10 if sending to State (Director of New Jersey)) 12 Employee identification number (EIN)

For Privacy Act and Paperwork Reduction Act Notice, see page 4. Cat. No. 102092 Form W-4 (2018)

1040-ES FORM: Taxpayers who are self-employed don't necessarily receive a paycheck with an employer withholding funds for prepayment of income taxes and FICA. Therefore, self-employed taxpayers make what are called estimated tax payments using form 1040-ES. The estimated payments are just that, an estimate of how much the self-employed taxpayer will owe in income taxes and FICA contributions based on the income of the taxpayer. The estimated tax payments are paid quarterly during the year starting in April, then again in June, September, and January of the following year. If estimated payments are more than the required tax liability, there is a refund of the difference. If the estimated payments are less than the tax liability, the taxpayer owes a balance due. If the estimates by the taxpayer are too low, the taxpayer can also be fined.

Form 1040-ES
Department of the Treasury
Internal Revenue Service

2018 Estimated Tax

Payment Voucher 1

OMB No. 1545-0074

Calendar year—Due April 17, 2018

File only if you are making a payment of estimated tax by check or money order. Mail this voucher with your check or money order payable to "United States Treasury." Write your social security number and "2018 Form 1040-ES" on your check or money order. Do not send cash. Enclose, but do not staple or attach, your payment with this voucher.

Amount of estimated tax you are paying by check or money order.

Dollars	Cents
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Print or type

Your first name and initial	Your last name	Your social security number
If joint payment, complete for spouse		
Spouse's first name and initial	Spouse's last name	Spouse's social security number
Address (number, street, and apt. no.)		
City, state, and ZIP code. (If a foreign address, enter city, also complete spaces below.)		
Foreign country name	Foreign province/country	Foreign postal code

For Privacy Act and Paperwork Reduction Act Notice, see instructions.

Form 1040-ES (2018)

W-2 FORM: The W-2 form is formally called the Wage and Tax Statement form. It is the official record of how much a taxpayer earned from a particular employer in that tax year. It provides the taxpayer and the state and federal income tax agencies, along with the Social Security Administration, with the amount of gross income earned by the employee, the withholdings for state and federal taxes, as well as FICA. It also provides information regarding withholdings for health care benefits paid for and provided to the employee by the employer. It shows the amount of contributions made by and employee for retirement. The W-2 must be sent to the employee by the employer by the end of January following the tax year. Employees must use their W-2(s) to file their state and federal tax returns.

W-2 Wage and Tax Statement

2017

Department of the Treasury—Internal Revenue Service

Copy B—To be Filed With Employee's FEDERAL Tax Return

This information is being furnished to the Internal Revenue Service.

Employee's social security number

OMB No. 1545-0048

Safe, accurate, FAST file

Visit the IRS website at www.irs.gov/efile

b Employer identification number (EIN)	1 Wages, tips, other compensation	2 Federal income tax withheld
c Employer's name, address, and ZIP code	3 Social security wages	4 Social security tax withheld
d Control number	5 Medicare wages and tips	6 Medicare tax withheld
e Employee's first name and initial Last name	7 Social security tips	8 Allocated tips
f Employee's address and ZIP code	9 Verification code	10 Dependent care benefits
15 State Employer's state ID number	11 Nonqualified plans	12a See instructions for box 12
16 State wages, tips, etc.	12b	12c
17 State income tax	12d	12e
18 Local wages, tips, etc.	13	14
19 Local income tax	14	15
20 Locality name		

FEDERAL INSURANCE CONTRIBUTIONS ACT (FICA): While already discussed in Chapter 9 in regards to determining income for the purposes of spousal and child support obligations, FICA is worth discussing here again. FICA is the acronym for the Federal Insurance Contributions Act. This is the law passed in 1935 that created Social Security. FICA is a contribution, (not technically a tax) that all employees and employers pay for Social Security and Medicare benefits. It is withheld from an employee's paycheck and paid to the federal government. Employers also match these payments. If a person is self-employed, they pay both the employee and employer amount. The percentage of an employee's income that is used to determine FICA is 6.2% for Social Security plus 1.45% for Medicare. There is a cap on income at which point the 6.2% for Social Security is no longer deducted from an employee's paycheck. That amount in 2018 is \$128,700 and can change each year pursuant the tax code.

As mentioned earlier in this chapter, approximately 46% of taxpayers do not pay federal income taxes. However, all taxpayers pay FICA. While FICA is technically not called a tax, it is a significant withholding from all taxpayers incomes. It is based on the taxpayer's gross income, not taxable income.

INCOME TAX FORMS: While in the past there were three federal personal income tax return forms that taxpayer's could choose from, the 1040EZ, 1040A, and 1040, under the Tax Cuts and Jobs Act of 2017, there is only one federal personal income tax return form that all taxpayers will use, the 1040.

