

## Theme 3 – Budgeting: Taxes

---

### 1) Tax Categories (three main types; there are others):

#### a) Income taxes

- i) **Ordinary Income** (e.g., wages) that shows up on your W-2; from **working**
  - (1) Deducted from your paycheck by your employer
  - (2) Federal Income Tax (FIT)
    - (a) **Progressive** – **rate** increases as income increases (NOT the same as TAXES increase)
  - (3) State Income Tax (SIT)
    - (a) **Progressive** – **rate** increases as income increases (similar to FIT, but different percentages)
    - (b) [Is it better to live in a state that does not collect State Income Tax?](#)
  - (4) Local Income Tax (LIT)
    - (a) NOT common, at least in NJ; NYC has one. Read more about Local Income Taxes [here](#).
  - (5) **FICA** (and [here](#))
    - (a) Social Security: 6.2% of income [up to a certain level](#) (\$132,900 in TY2019), no tax after that level
    - (b) Medicare: 1.45% of all income (rate is higher on income over \$200K)
    - (c) Paid by employee, **matched dollar-for-dollar**, by employer; if you're self-employed, you pay **both**
    - (d) Trivial! [Ida May Fuller](#)
- ii) Other sources of income that are NOT part of your paycheck (usually shown on a [form 1099](#))
  - (1) **Capital Gains** - sale of certain assets for a profit
    - (a) Profit is taxed like income if you've held the following **for one year or less**; ([learn more about short-term vs long-term capital gains taxes](#)) otherwise, it [taxed at a lower rate](#)
    - (b) Examples:
      - (i) Selling stocks, mutual funds, etc.
      - (ii) Selling Real estate
      - (iii) Selling collectibles (art, classic cars, etc.) for a profit
  - (2) **Dividends** – some corporations choose to share their profits with their owners/shareholders while others reinvest it into the business; if you get dividends, they are taxed as ordinary income (click [here](#) for more info and short video on cash dividends)
  - (3) **Interest** – usually from a savings or checking account; taxed as ordinary income
  - (4) **Other** – lottery winnings, unemployment benefits received, working as an [independent contractor](#), etc.

#### b) Property taxes – paid by property owners, including people and businesses

- i) If you own your home (no mortgage), you pay directly to your local/town government
- ii) If you are paying off a mortgage, your bank will likely collect this \$ from you & pay the taxes on your behalf
- iii) If you pay rent, the landlord/property owner pays the tax but, of course, that's passed on to the tenant
- iv) Three main parts (Pway percentages shown):
  - (1) Schools (~56%): Pays for public schools
  - (2) Municipal (~28%): Pays for police, fire, EMT, town government, town roads/bridges, etc.
  - (3) County (~16%): Libraries, parks, county roads, courts, etc.
- v) What happens if you don't pay your taxes? ([tinyurl.com/p5qqz4h](http://tinyurl.com/p5qqz4h))
- vi) **Property Tax** is a **flat tax** – the **rate** doesn't change!

#### c) State Sales Tax

- i) State Sales tax is a consumption tax – the more you consume (buy) the more you pay
- ii) As of January 1, 2018, it's **6.625%** on non-essentials (most things); essentials are not subject to sales tax  
To see how confusing it can get in NJ, [look at the list](#).
- iii) **3.3125%** in 27 NJ [Urban Enterprise Zones](#) ([map](#)) – to encourage businesses and community development (don't memorize the rate; just know that the rate is half the normal rate in these cities/zones)
- iv) Collected by the seller/merchant at the time of purchase and forwarded to the state treasury on a regular basis; the only record of it is on your receipt (i.e., your employer does not, and should not, know)

## 2) Forms

- a) [DHS Form I-9 \(purpose of I-9\)](#) “Employment Eligibility Verification”
  - i) **“First day” form** – you’ll need to complete one on or before your first day at a new job
  - ii) Employer retains form in case of audit/problem (you don’t get a copy)
  - iii) Confirms legal status for employment purposes
- b) [IRS Form W-4 \(purpose of W-4\)](#) “Employee’s Withholding **Allowance** Certificate”
  - i) **“First day” form** – you’ll need to complete one on or before your first day at a new job; tells employer how much tax to deduct from your paycheck
  - ii) Employer retains form after entering info into payroll system
  - iii) Determines how much INCOME TAX is withheld from paycheck
    - (1) Marital status: Single vs married (married = less withholdings)
    - (2) Allowances: 0 through 7 (**more allowances = less withholdings**)
  - iv) Most of you will use “S-0” (max withholding) for your first job, and probably get a refund after filing 1040EZ
- c) [IRS Form W-2 \(purpose of W-2\)](#) **← answers several test ?s** “Wage and Tax Statement”
  - i) Issued **by employer** to employee no later than January 31st **for prior year’s earnings**
  - ii) Required in order to complete your tax return
  - iii) [This video](#) **answers several test ?s** – a worthy investment of 2 minutes of your time
  - iv) Should match your final paystub **of previous year**; shows things like total earnings, total taxes withheld, etc.
- d) [IRS form 1040](#) (and [here](#), with introduction)
  - i) This is your tax return: “Squaring up” – after each year you have to see if you had too much tax withheld (= you are entitled to refund) or too little withheld (= get ready to write a check for the additional amount owed).
  - ii) **You** are responsible for completing and sending to IRS on or before April 15<sup>th</sup> (or next business day if the 15<sup>th</sup> is not a business day). If you owe \$, possible interest and penalties if you’re late. If IRS owes you and you wait too long, you may FORFEIT your refund!
  - iii) [What if you make a mistake on your tax return? \(and here\)](#)
  - iv) Gross income - tax deductions\* = taxable income **← KEY CONCEPT!**
    - (1) [Standard deduction vs itemized deductions](#) (also see <https://abcn.ws/2DmnMOX>)
      - (a) TAX deductions are good, so take the bigger deduction if you can do so legally (you might have to do some math to determine which is bigger; software figures this out for you)
      - (b) Property tax, big medical bills, & mortgage interest frequently mean taking itemized deductions → lower taxable income → less tax owed
      - (c) **Itemized** is more work and requires good record-keeping but the math (addition) is easy!
- e) [Form 1099](#): for other income (contractor income, dividends, taxable interest, unemployment benefits, lottery winnings, etc.)

## 3) Tax Brackets and Rates

- i) Your WAGES may be taxed at different rates
  - (1) Many (7) different FEDERAL income tax brackets (**10%**, 12%, 22%, 24%, 32%, 35%, **37%**): [details](#)
  - (2) Many (6) different STATE income tax brackets (1.4, 1.75, 3.5, 5.525, 6.37, 9.97%) in New Jersey (do not memorize NJ rates)
  - (3) The income in each bracket is taxed at a different rate **← KEY CONCEPT!**
  - (4) [Tax Brackets and Rates](#)
- ii) Marginal vs effective tax rate (both given as a percent)
  - (1) **Marginal**: if you made ONE MORE DOLLAR, what tax bracket would that dollar be in?
    - (a) <http://tinyurl.com/owrknah>
  - (2) **Effective**: basically, an **average rate** (total tax paid / total taxable income)
    - (a) <http://tinyurl.com/7psp43u>

\*Tax deductions are VERY different from *paycheck* deductions – know the difference! **← KEY CONCEPT!**

This is a **GUIDE ONLY**; class activities, discussion, notes, packets, the [provided resources](#), etc., are all part of your learning and will help you prepare for the test.