

Chp. 10 - Activity 3

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>> LESSON 2

Taxes:

Who's FICA, and Why Does He Get Part of My Paycheck?

The United States employs a progressive federal tax system, which means the tax rate increases as income increases. Presented below are the federal individual income tax rates for 2009.¹

If your taxable income is between:	The tax rate is:	The tax is:
\$0 and \$8,350	10%	10% of the amount between \$0 and \$8,350
\$8,350 and \$33,950	15%	\$835, plus 15% of the amount between \$8,350 and \$33,950
\$33,950 and \$82,250	25%	\$4,675, plus 25% of the amount between \$33,950 and \$82,250
⑥ \$82,250 and \$171,550	28%	\$16,750, plus 28% of the amount between \$82,250 and \$171,550
\$171,550 and \$372,950	33%	\$41,754, plus 33% of the amount between \$171,550 and \$372,950
\$372,950 or more	35%	\$108,216, plus 35% of the amount over \$372,950

To illustrate how taxes are calculated under a progressive tax system, assume your taxable income is \$50,000, which means you fall within the 25% "tax bracket." Therefore, your federal taxes are equal to \$4,675, plus 25% of the amount over \$33,950. Therefore, your federal tax is \$8,687.50:

$$\begin{aligned}
 &= \$4,675 + [25\% \times (\$50,000 - \$33,950)] \\
 &= \$4,675 + [25\% \times \$16,050] \\
 &= \$4,675 + \$4,012.50 \\
 &= \$8,687.50
 \end{aligned}$$

Or,

$$\begin{aligned}
 &= [10\% \times \$8,350] + [(15\% \times (\$33,950 - \$8,350))] + [25\% \times (\$50,000 - \$33,950)] \\
 &= \$835 + [15\% \times \$25,600] + [25\% \times \$16,050] \\
 &= \$835 + \$3,840 + \$4,012.50 \\
 &= \$8,687.50
 \end{aligned}$$

④ The tax rates shown above are used to calculate federal income taxes. In addition to federal income taxes, most states also assess a state income tax. In Connecticut, income between \$0 and \$10,000 is taxed at 3% and income greater than \$10,000 is taxed at 5%.

* You need to consider both 3% and 5%
¹Tax rates for individuals that file as single. for Ray's taxes!

Whereas federal income taxes are based on taxable income, Connecticut state income taxes are based on gross income.

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FICA

In addition to federal and state income taxes, Social Security taxes — more commonly known as “FICA” taxes — are deducted from your income. The **Federal Insurance Contributions Act (FICA)** is a payroll tax paid by both employees and employers to fund Social Security and Medicare, federal programs that provide benefits for retirees, the disabled, and children of deceased workers.

① Both employees and employers pay 6.2% of your salary, up to an annual limit of \$106,800² for Social Security taxes, and 1.45% of your salary for Medicare taxes. (There is no income limit on Medicare tax.) Self-employed individuals pay both the employer and employee share of Social Security (12.4%) and Medicare (2.9%) taxes.

Income Taxes

Taxes are deducted each pay period as a means to pre-pay your tax obligation at the end of the year. Taxpayers must complete and file **Form 1040**, the U.S. Individual Income Tax Return, with the Internal Revenue Service (IRS) by April 15th of each year for the preceding year. The purpose of filing Form 1040 is to determine if additional taxes are required to be paid or if taxes paid during the year are in excess of the amount owed and a refund is in order. In addition, Connecticut residents must report their income and taxes by filing **Form 1040-CT** with the Connecticut Department of Revenue Services.

The amount of income subject to tax is called **taxable income**, which is equal to your gross income, less exemptions and other allowable deductions. Gross income is all income earned, such as wages, interest, dividends, and business income. A **tax exemption** reduces the amount of income subject to tax. Taxpayers are granted a \$3,650³ exemption for themselves and every dependent. A dependent is someone related to the taxpayer or someone the taxpayer supports financially, such as their spouse and children.

Taxpayers are also allowed deductions, which reduce their taxable income. Taxpayers can deduct the greater of the **standard deduction** (\$5,700⁴) or “**itemized deductions**.” Itemized deductions include medical expenses, state income taxes, interest on home mortgages, donations and gifts to charities, and other allowable miscellaneous expenses. Itemized deductions are reported on **Schedule A** and filed with Form 1040.

Form W-2

Form W-2 reports your prior year's salary and tax (federal income tax, state income tax, Social Security tax, and Medicare tax) withheld during the year. Form W-2 is prepared by employers and provided to employees at the end of the year and is used to complete individual income tax forms.

Paying part of your tax obligation each pay period is referred to as “paying as you go.”

Form W-4

Employees complete Form W-4 to determine the amount of federal income tax to be withheld (deducted) from each paycheck. The amount deducted is based on your marital status (single or married), the number of allowances claimed (usually equal to the number of dependents), and your salary. Each allowance claimed reduces the amount of tax withheld; therefore, the greater the number of allowances, the less tax withheld.

²For 2009

³For 2009

⁴For 2009

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Activity 1: Another Day, Another Dollar—or 70¢ After Taxes!

Gross Income

Ray is single with no dependents and lives in Connecticut. In 2009, he earned \$125,000 working as a senior manager for a CPA firm.

- What amount of Social Security tax and Medicare tax would be withheld from Ray's salary for the year?
See pg. 9 \$8,434.10 → this is the answer for #1
- What amount of Social Security tax and Medicare tax is paid by Ray's employer, the CPA firm, on his behalf?
See pg. 9
- What is Ray's gross income if he earned \$5,000 in interest and dividends from investments? (Add)
- How many exemptions can Ray claim and what amount can he deduct from his gross income based on those exemptions?
hint: he's single (See pg. 9)
- If Ray paid \$10,000 in interest on a mortgage, had \$6,000 of state income taxes withheld during the year, and gave charitable donations of \$3,000 during the year, what are his total itemized deductions and taxable income?
mortgage = house loan
Add interest + taxes + donations = itemized deductions, then subtract them from his taxable income.
- What is Ray's federal income tax?
(see chart) \$23,778 → this is the answer for #6
- If Ray had \$20,000 of federal taxes withheld during the year, determine whether Ray would owe additional taxes or be due a refund, and the amount.
(you need info. from #6 to figure this one out) → based on how he filled out his W-4, which told his employer how much \$ to withhold from each pay check.
- What is Ray's state income tax?
See pg. 8
- Ray had \$6,000 of state taxes withheld during the year. Determine whether Ray would owe additional state taxes or be due a refund, and the amount.
Use your answer from #8 to figure out this answer.
- What is the total amount of taxes Ray will pay for the year?
Add All taxes Soc. Sec. + Medicare (#1), Federal tax (#6), State tax (#8) = _____
- What percent of Ray's income is paid in taxes?
total taxes ÷ total income (don't forget to include interest income + dividends)
- Based on Ray's federal income tax, state income tax, Social Security tax, and Medicare tax for the year, estimate the amount of each tax and the total tax that should be withheld each pay period if Ray is paid twice per month.
There are a few ways to figure this (use your problem solving skills)
- Based on your estimate of the tax that should be withheld each pay period, estimate Ray's take-home pay.
Again... you can do this! Think...