Lesson 3

Income Tax

My first real paying job was working at a local deli. When I was hired, I was told that my hourly wage would be $1.45 per hour. That may not seem like much, but this was the minimum wage at the time (a long time ago). I think I worked 28 hours the first week, and I thought I would receive a check for $40.60. I was surprised to receive much less than I expected because a whole bunch of taxes had been taken out.

Since then the minimum wage has increased, and so has the tax burden. If you are currently working and receiving a paycheck, you will have shared the unpleasant experience of seeing your take-home pay be much less than your gross pay. I am getting ahead of myself, so let's define some terms before we embark on this topic of taxes.

Your Earnings

Gross pay is what you earn, whether by salary, hourly wage, piecemeal reimbursement, or commission. It is what you think your income will be. Net pay, or take-home pay, is what you really take home after the government has taken its cut of your income. This tax on your income is called income tax.

Employer and Employee

Employers are those who hire you and pay you for your work. Those of us who are hired are referred to as employees. The employer and the employee have similar but different responsibilities for paying taxes on what is earned.

I am responsible to pay several different kinds of taxes: federal (United States), state (Pennsylvania), and county (Lancaster). Unless you are my next-door neighbor, your taxes will be different, since the taxes and tax rates vary from country to country, state to state, county to county, and school district to school district. Let's examine a few of these income taxes, so that you will better understand your paycheck.

Graduated Tax

There are two different ways of taxing income. One is called a graduated tax. This means that the more money you earn, the greater the percentage of your earnings you pay in taxes. For 2018, if your taxable income is less than $9,525.00, you are responsible to pay 15% of your taxable income in federal tax. If you make between $38,701.00 and $82,500.00, you are in a higher bracket (there are seven brackets which are listed below), and you will pay 24% of your taxable income. The greater the amount of your taxable income, the higher your percentage.

Flat Tax

A flat tax requires everyone to pay the same income tax rate regardless of how much or how little they earn. There is one rate for everyone. Forty-three states have a state income tax.

Thirty-five of them use a graduated tax formula while eight states have a flat tax. Seven states do not have any state income tax. Some people are proponents of a federal flat tax on income instead of a graduated tax. There are advantages to both, but the flat tax is much simpler and would drastically cut back on the cost to the Internal Revenue Service (IRS) of administering the graduated tax model.

Taxable Income (Federal)

As of January 1, 2018, a single person filing their own tax return receives a $12,000.00 standard deduction. This means that if you earn $62,000.00, you can deduct $12,000.00 and compute your taxes on only $50,000.00 ($62,000.00 – $12,000.00). This amount of $50,000.00 is called your taxable income.

Federal Withholding Tax

This tax is a graduated tax and therefore depends on how much you earn in a year. This is taken from your paycheck by your employer and is usually deposited in a local bank, and then transferred to the Internal Revenue Service, or IRS. When you are hired by your employer, you will be asked to fill out a W-4 form, which determines how many allowances you can claim. Having more allowances means you can have less taxes taken out of each paycheck.

Filing Individually or Jointly

When you fill out your tax return, if you are single, you will select the option to be considered as an individual. Someday when you are married, you and your spouse may each file individually, or you may file jointly. If you look at the tax tables for Federal Withholding Tax, notice these two options. The tax rates are graduated and computed on what your net income is. If you and your spouse each make $50,000 annually, examine whether it is better to file your taxes individually or jointly. In the first section you would fall into the 22% bracket. In the second section, your combined income would be $100,000 and you are still responsible to pay 22%. Until you reach the last two brackets for 35% and 37%, there is no difference between filing individually or jointly.

2018 Income Tax Brackets

Rate	Filing as an Individual	Filing Jointly
10%	$0 to $9,525	$0 to $19,050
12%	$9,526 to $38,700	$19,051 to $77,400
22%	$38,701 to $82,500	$77,401 to $165,000
24%	$82,501 to $157,500	$165,001 to $315,000
32%	$157,501 to $200,000	$315,001 to $400,000
35%	$200,001 to $500,000	$400,001 to $600,000
37%	over $500,000	over $600,000

Computing your Annual Federal Income Tax Using these Seven Brackets

If you are single and have a gross income of $47,000.00, how would you compute your Federal Income Tax? The first step would be to subtract $12,000.00, which is your standard deduction. Your taxable income is $35,000.00.

The first $9,525 will be taxed at a rate of 10%, which is $952.50
Subtracting $9,525.00 from $35,000 yields a balance of $25,475
This amount is taxed at the 12% rate
$\$25,475 \times 0.12 = \$3,057.00$
Adding the two amounts: $\$3,057.00 + \$952.50 = \$4,009.50$

Net Tax Rate

You did not pay any taxes on your first $12,000 because of the standard deduction. You paid 10% on your next $9,525.00 and 12% on your final $25,475.00, so you ended up paying $4,009.50, which is 8.53% of your gross pay. I calculated this percent by dividing $4,009.50 by $47,000 to get 8.53%.

Weekly Deductions Of Federal Income Tax

Federal income tax withheld is calculated using the Wage Bracket Method and is determined by the information on your W-4 form. The W-4 will determine how many allowances you can claim. I am including a few lines from the table for 2018 for an example.

		Witholding Allowances Claimed			
Wages are at least	but less than	0	1	2	3
890	900	103	86	76	66
900	910	105	88	77	68
910	920	108	90	78	69

State Income Tax

Pennsylvania is one of eight states that has opted for a flat income tax. It has a flat rate of 3.07%. If you live in Pennsylvania, this means that 3.07% of your gross pay is deducted from your paycheck by your employer, and then sent directly to the Pennsylvania State Treasury.

Since your income is $47,000, you also pay 3.07% for state income tax. This is a flat tax for PA residents and comes out to $\$47,000 \times 0.0307 = \$1,442.90$.

County Income Tax

In my county (Lancaster), the rate varies for each local school district. Our school district rate is 1.0%. This is one of the smaller taxes and is taken from the paycheck and sent directly to the Lancaster County Treasurer. The county then distributes the money to the school districts and local municipalities. I learned in my research that there is an additional tax in my county called the Local Services Tax, which is $52.00 a year per employee. Generally, if you are a full-time employee this amount is withheld at a rate of $1.00 each week. I called the county tax collection agency twice, and no one can tell me what it is for, but it is another tax I have to pay.

FICA

This acronym stands for Federal Insurance Contribution Act and is the first of several federally imposed payroll taxes. I call these taxes "double dips" because not only does the government take 6.20% from your paycheck for the Social Security portion, but the employer has to match the "contribution" and pay 6.20% as well. FICA funds both Social Security and

Medicare. The rate for the Medicare portion is 1.45%. It, too, is matched by the employer. Both of these taxes, Social Security and Medicare, are part of the money deposited at the local bank by the employer and then sent to the government. When you add them up, you have a FICA tax of 7.65%. There are maximum contribution thresholds, but this rate will apply to most of us.

SUI

State Unemployment Insurance (SUI) is put into a fund and then withdrawn by those who have lost their jobs or are out of work. The employee rate is 0.06% on all of his or her annual earnings. The employer pays anywhere between 2% and 10%. This tax is instituted when there are high unemployment rates, and varies from year to year. There are maximum contribution thresholds, but the 0.06% rate will apply to most of us.

A Paycheck

If you are an adult and are not being claimed as a dependent on your parents' tax returns, you will have to pay taxes. If you are earning an annual salary of $47,000, your weekly gross pay is $904. Here is what your paycheck might like after your taxes have been withheld, if you work in Lancaster County, Pennsylvania in 2018 and didn't claim any allowances on your W4 form.

Example 1

Federal	$105.00	(about 11%, could vary)
State	$27.75	3.07%
County	$9.04	1.00%
LST	$1.00	fee
FICA (SS + Medicare)	$69.16	7.65%
SUI	$0.54	0.06%
Total Deducted Weekly Tax	$212.49	
Net Take Home Pay	$691.51	

Employer Taxes

The employer also must pay taxes on what you earn. Those taxes don't come directly out of your paycheck. You may see them referred to as employer expenses. Most of the employer taxes have been mentioned, but here they are spelled out again. The one new tax is FUTA, which stands for Federal Unemployment Tax Act. It is 6% but is only computed on the first $7,000.00 of wages earned.

Example 2

(based on $904 weekly gross pay from Example 1)

FUTA	$54.24	6.00%
FICA (SS + Medicare)	$69.16	7.65%
SUI	$18.08	2.00%
Total Employer Taxes	$141.48	

Self-Employed Federal Estimated Quarterly Tax Payments

Your annual income will vary each year if you are self-employed. You are required to make estimated tax payments based on the previous year's income. These dates may vary from year to year, and depending on whether your fiscal year corresponds to the calendar year. Here are the due dates for the 2019 calendar year.

Quarter	Payment Due
January–March	April 15
April–May	June 17
June–August	September 16
September–December	January 15

Suppose you made $47,000.00 last year, reported this amount on your federal tax return, and paid $4,009.50 in taxes. Divide the total tax into four equal payments. You must pay $1,002.38 estimated tax per quarter this year.

Example 3

Ned and Leslie made a gross income of $81,700.00 last year as self-employed graphic designers. How much should they pay in estimated quarterly payments?

Solution 3

First we must determine how much they paid in taxes.
Since they are married and filing jointly, they can subtract their standard deduction of $24,000.00 from $81,700.00. Their taxable income is $57,700.00.
The first $19,050.00 of taxable income will be taxed at a rate of 10%, which yields $1,905.00.
Subtracting $19,050.00 from $57,700.00 yields a balance of $38,650.00, which is taxed at the 12% rate.
$\$38{,}650.00 \times 0.12 = \$4{,}638.00$
Adding the two amounts: $\$1{,}905.00 + \$4{,}638.00 = \$6{,}543.00$
$\$6{,}543.00 \div 4 = \$1{,}635.75$.

Self-Employed State Estimated Quarterly Tax Payments

If you made $47,000.00 the year before, reported this amount on your state tax return, and paid $1,442.90 in taxes, divide this amount into four equal payments of $360.73.

Example 4

Paula has a dog sitting business. She makes an average of $400.00 per month. Last year she showed a net taxable income of $5,000.00. How much should she pay in estimated quarterly payments if her state income tax is 3.07%?

Solution 4

$\$5{,}000.00 \times 3.07\% = \$153.50$
$\$153.50 \div 4 = \$38.375$, which rounds to $38.38

Plan For FICA

When you are self-employed, you are both the employer and the employee. Since each party normally pays 7.65% for FICA, as both the boss and the worker you will pay 15.3% (ouch). There may be some deductions which will impact this amount, but you should count on this tax being close to 15.3% of your income. If you make $47,000.00 a year, the FICA tax will be $7,191.00. Start setting aside money now so you can pay this when your taxes are due by April 15 of the next year.

Example 5

Paula (Example 4) wants to set aside money for her FICA taxes. How much should she have in her savings account by April 15 of the next year?

Solution 5

$\$5{,}000.00 \times 15.3\% = \$765.00$