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Federal Individual Income Tax Terms: An Explanation

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Summary

The most commonly used terms in discussing the federal individual income tax are described in this report. Most of these tax terms are explained in the order that they occur in the process of determining one's income tax on the Form 1040. Even before sitting down to calculate taxes, however, most individuals have a general idea of their total **economic income**, which is the broadest measure of all income, whether tax-relevant or not, and is an economic concept rather than one contained in the tax code. **Gross income** is the sum total of all income required to be reported for tax purposes before adjustments to income are made for special types of expenses which Congress has determined should be considered in calculating gross income. These adjustments function like deductions, except that unlike deductions, adjustments are calculated in arriving at adjusted gross income, and thus can be claimed by all taxpayers, not just those who itemize deductions. An **exclusion** from income refers to an item specifically excluded from determination of gross income.

Adjusted gross income (AGI) equals gross income less qualifying adjustments to income. It serves as the base for computing limits on certain itemized deductions and is the income measurement before deductions and personal exemptions are taken into account. **Deductions** from adjusted gross income are allowed for certain types of expenditures for which income taxation is deemed inappropriate or inadvisable. Deductions function like adjustments and exclusions in their effect on tax liability. In addition to the standard deduction, an additional standard deduction amount is available to elderly and blind taxpayers. Personal **exemptions** are allowed for the taxpayer, his spouse and each of his dependents. Exemptions affect tax liability like deductions, adjustments to income, and exclusions.

Taxable income is adjusted gross income reduced by either the standard deduction (plus the additional standard deduction in some cases) or itemized deductions along with personal exemptions. Taxable income is the base to which the income tax rates are applied to calculate income tax liability. **Gross tax liability** is calculated by applying the marginal tax rate and structure to taxable income; it serves as a base amount prior to subtraction of tax credits. **Tax credits** are subtracted from gross tax liability to arrive at a taxpayer's final tax liability. Hence, tax credits reduce tax liability directly, on a dollar for dollar basis. Tax credits are available to all qualifying taxpayers, whether they itemize deductions or not. **Final tax liability** is the amount of federal income tax owed by the taxpayer to the federal government after taking into account allowable tax credits. When a taxpayer's final tax liability exceeds federal taxes withheld, estimated quarterly taxes paid, and certain other credits, then the taxpayer has **taxes due** and must pay the federal government additional federal income taxes to cover the shortfall. A **refund** is a payment by the federal government to a taxpayer whose withheld taxes and/or estimated tax payments or refundable credits exceeded his final tax liability.

A flow chart illustrating the relationship among the income tax terms discussed in this report appears on the final page.

This report will be updated as warranted by legislative events.

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Economic Income

Economic income is the broadest measure of all income, and is an economic concept rather than one contained in the tax code. Commonly referred to by economists as the Haig-Simons definition of income, total or "net" income is defined as increases in a taxpayer's net worth plus the monetary value of consumption over a given time period. Often, it is difficult to determine the exact amount of such income. For example, a health club employee may be allowed free access to the facilities after work hours by his or her employer. Under an economic definition of income the use of the health club constitutes income because others would have been required to pay for the use of the same club facilities. Another example of economic but not monetary income is the imputed rental value of owner-occupied housing, which is not subject to income tax.

Gross Income

Gross income is the broadest measure of income used for tax purposes. It is the total of all realized income recognized by the tax law that is not specifically tax exempt. It is measured net of business expenses but before any other deductions or adjustments. It includes employee compensation such as wages, salaries and tips, taxable interest and dividend income, business and farm income (net of expenses), realized capital gains, income from rents, royalties, trusts, estates, and partnerships, and taxable pensions and annuities. Gross income does not include items of income explicitly excluded from tax (see the following section on "Exclusions").

Exclusions

An exclusion is an item of income that is not included in gross income because the tax code explicitly exempts it from tax. Examples of items of income which are exempt[1] from federal income taxation and, hence, excluded from gross income, are state and local bond interest income, public assistance (welfare), small gifts, and the

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[1] The expression "tax-exempt" is used to describe types of income and organizations that are not subject to taxation. Interest income from state and local bonds, for example, is exempt from federal income taxes. Certain qualifying nonprofit organizations are exempt from federal income taxation. The provisions are not, however, described as exemptions on the tax return. They are more properly termed "exclusions."

tax-exempt portion of pensions and annuities. Social security and railroad retirement income may or may not be excluded from income subject to tax. The taxability of social security and railroad retirement depends on the amount of other income the taxpayer receives.

Also, not considered as taxable income are a clergy member's tax-free housing allowance, qualified foster care payments, and qualified scholarship and fellowship grants. Under certain conditions, a taxpayer can exclude a limited amount of disability pay such as workers' compensation. Except for tax-exempt interest, exclusions generally are not required to be reported to the Internal Revenue Service.

Adjustments to Income

Adjustments to income are those items of expenditure that are deducted from gross income in arriving at adjusted gross income. These may include payments to Keogh or traditional (but not Roth) individual retirement arrangements (IRAs), forfeited penalty on early withdrawal of savings, interest paid on student loans, moving expenses, and alimony payments. Adjustments to income function similarly to deductions. However, unlike deductions, adjustments are made to arrive at adjusted gross income, and hence can be claimed by all qualified taxpayers, whether or not they use the standard deduction amount or have itemized deductions (see "Deductions").

Adjusted Gross Income (AGI)

Adjusted gross income (often referred to as AGI) is the basic measure of income under the federal individual income tax. Adjusted gross income equals gross income less qualifying adjustments to income. Components of adjusted gross income include wages, salaries, tips, and other compensation, dividend and interest income, realized capital gains, business and farm income, and income from royalties, trusts, estates, partnerships, rents, and taxable pensions and annuities. The sum of income received from these sources is reduced by the adjustments previously discussed to arrive at adjusted gross income. Adjusted gross income serves as the base for computing many limits under the tax law, such as those on the medical expense and miscellaneous itemized deductions. Adjusted gross income is the income measurement before deductions and personal exemptions are taken into account.

Deductions

Deductions from adjusted gross income are allowed for certain types of expenditures of income for which income taxation is deemed inappropriate or inadvisable. Deductions function like adjustments and exclusions in their effect on tax liability. Deductions reduce a taxpayer's tax liability, but only by a percentage of the amount deducted. An individual in the 35% tax bracket would receive a reduction in taxes of $35 for each $100 deduction while an individual in the 25% tax bracket would receive a reduction in taxes of $25 for each $100 deduction. Hence, the same deduction can be worth different amounts to different taxpayers depending on their marginal tax bracket. More simply stated, the tax savings from deductions is generally equal to the taxpayer's tax rate times the amount of the deduction.

Deductions may be claimed by itemizing one's deductible expenses or by taking the standard deduction. Itemized deductions are allowed for many purposes, including certain medical expenses[2]; state and local property, income, and a few other taxes; home mortgage interest, points, and limited amounts of other interest paid (but not personal interest); contributions to charitable organizations; certain casualty and theft losses[3] less $100 per event; investment expenses; tax preparation fees; certain unreimbursed employee business expenses[4]; and a few other "miscellaneous" expenses. These itemized deductions are then totaled and subtracted from AGI.

The alternative way in which deductions may be claimed is by using the so-called standard deduction amount, which allows taxpayers to remove a fixed portion of their adjusted gross income from taxation without itemizing deductible expenses.

The standard deduction amounts for 2006 are $10,300 for married taxpayers who file a joint tax return; $5,150 for single taxpayers; and $7,550 for taxpayers who qualify as the head of a household. An additional standard deduction amount is available to those 65 or older and taxpayers who are legally blind. In 2006, this additional standard deduction is $1,250 for each qualifying taxpayer filing a joint return or qualifying widow(er) who is 65 or older or blind. The deduction rises to $2,500 if the taxpayer is 65 or older and blind. If taxpayers are married and both spouses are 65 or older *or* blind, an additional $2,000 is allowed on a joint return. If both spouses are 65 or older *and* blind, an additional $4,000 is allowed on a joint return. These amounts are adjusted annually for inflation.

Only individuals with deductions that can be itemized in excess of the standard deduction find it worthwhile to itemize. These tend to be taxpayers in the middle to high income ranges. The preliminary data for tax year 2003 indicate that approximately 33.6% of taxpayers itemize their deductions.

Exemptions

Personal exemptions are allowed for the taxpayer, his or her spouse (if married and filing a joint return), and each dependent. Each exemption claimed reduces income subject to taxation by $3,300 for tax year 2006 (this amount is adjusted for inflation annually). The personal exemptions combined with the standard deduction amount are designed to remove low — income households from the tax rolls, and exempt a minimum level of income from taxation for other families.

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[2] Medical expenses in excess of 7.5% of AGI are deductible.

[3] Casualty and loss expenses in excess of 10% of AGI are deductible.

[4] Unreimbursed business expenses in excess of 2% of AGI are deductible.

Taxable Income

Taxable income, the narrowest measure of income used on the income tax return, is equivalent to adjusted gross income reduced by either the standard or itemized deductions and the personal exemptions. Taxable income is the base upon which the income tax rates are applied to calculate income tax liability.

Gross Tax Liability

Gross tax liability is calculated by applying the marginal tax rate and structure to taxable income. Gross tax liability serves as a base amount prior to subtraction of tax credits. The marginal tax rate and tax amounts on taxable income for tax year 2006 are provided in **Table 1**.

Table 1. Marginal Tax Rates and Tax Amounts for 2006

If *taxable income* is:	Then, *tax* is
Joint Returns	
$ 0 - $15,100	10% of the amount over $ 0
$ 15,100 - $61,300	$1,510 + 15% of the amount over $ 15,100
$ 61,300 - $123,700	$8,440 + 25% of the amount over $ 61,300
$123,700 - $188,450	$24,040 + 28% of the amount over $123,700
$188,450 - $336,550	$42,170 + 33% of the amount over $188,450
$336,550 +	$91,043 + 35% of the amount over $336,550
Single Returns	
$ 0 - $7,550	10% of the amount over $ 0
$ 7,550 - $30,650	$755 + 15% of the amount over $ 7,550
$ 30,650 - $74,200	$4,220 + 25% of the amount over $ 30,650
$ 74,200 - $154,800	$15,108 + 28% of the amount over $ 74,200
$154,800 - $336,550	$37,676 + 33% of the amount over $154,800
$336,550 +	$97,653 + 35% of the amount over $336,550
Heads of Households	
$ 0 - $10,200	10% of the amount over $ 0
$ 10,750 - $41,050	$1,075 + 15% of the amount over $ 10,750
$ 41,900 - $106,000	$5,620 + 25% of the amount over $ 41,050
$106,000 - $171,650	$21,858 + 28% of the amount over $106,000
$171,650 - $336,550	$40,240 + 33% of the amount over $171,650
$336,550 +	$94,657 + 35% of the amount over $336,550

Credits

Tax credits are subtracted from gross tax liability to arrive at a taxpayer's final tax liability. Hence, tax credits reduce tax liability directly, on a dollar for dollar basis.[5] Tax credits are available to all qualified taxpayers, whether they itemize deductions or not.

Tax credits can be divided into two categories, refundable and nonrefundable. Refundable credits are those which can exceed tax liability, resulting in a direct payment from the Treasury. (The direct payment is called a "refund" even when nothing has been paid to be refunded.) Non-refundable credits can only be used to the extent they eliminate tax liability; they cannot result in a payment that exceeds original tax liability.

Examples of nonrefundable credits are the credit for the elderly and the permanently and totally disabled, the credit for child and dependent care expenses, and the foreign tax credit. The primary refundable credits are the earned income tax credit and the child credit.

Final Tax Liability

Final tax liability is the amount of federal income tax owed by the taxpayer to the federal government after taking into account allowable tax credits. Thus, final tax liability represents the taxpayer's total federal income tax bill for the tax year. A taxpayer's final tax liability may be negative, if the amount of refundable tax credits exceeds his or her calculated tax bill before allowing for the credits.

Taxes Due

When a taxpayer's final tax liability exceeds federal taxes withheld over the course of the tax year, estimated quarterly taxes paid, and certain other credits, then the taxpayer will owe the federal government an additional amount to cover the shortfall in withheld or previously paid taxes.

Tax Refund

A tax refund is a payment by the federal government to a taxpayer whose withheld taxes, estimated tax payments, or credits exceeded final tax liability, entitling him or her to a refund to remedy having overpaid the tax bill. A taxpayer

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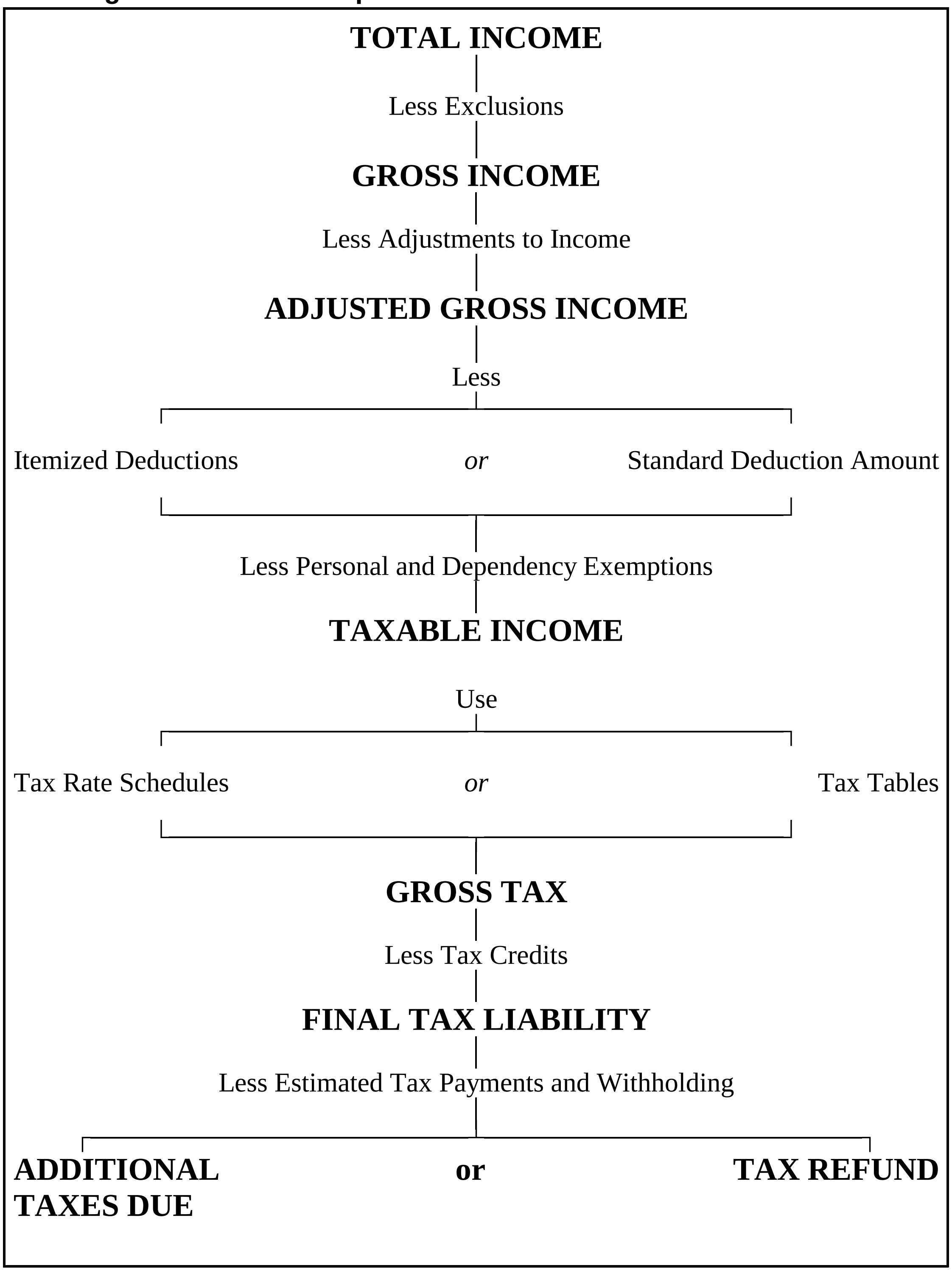
[5] A tax credit of a given amount reduces a taxpayer's taxes by more than a deduction of the same amount since it is subtracted directly from tax liability. For example, for each $1 tax credit a taxpayer's tax liability is reduced by $1, while each $1 deduction reduces income subject to tax by the marginal tax rate of the taxpayer (e.g., $0.35 for someone in the 35% tax bracket).

with negative tax liability may also be entitled to a tax refund, although this refund is not a refund of overpaid taxes, but a payment of a negative tax.

A flow chart illustrating the relationship among the income tax terms discussed in this report appears in **Figure 1**.

Figure 1. Relationship Between Individual Income Tax Terms



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