

# Taxes: Understanding the basics

## What are taxes?

Taxes are required payments of money to governments, which use the funds to provide public goods and services for the benefit of the community as a whole. Understanding taxes is an important part of managing your money, both now and in the future.



## What types of taxes are there?

Common types of taxes include income, payroll, sales, and property taxes.

*Income taxes* are federal, state, and local taxes that may be collected on income, both earned (salaries, wages, tips, commissions) and unearned (interest, dividends). Most of the federal government's revenue, or money it receives, comes from income taxes. Not all states and localities have income taxes, and the government may not collect income tax if your income is below a set amount.

You can change the amount of income tax you owe by claiming tax credits and deductions on your tax return:

- A tax deduction is an amount (often a personal or business expense) that reduces income subject to tax.
- A tax credit is a dollar-for-dollar reduction in a tax. It can be deducted directly from taxes owed. Tax credits can reduce the amount of tax you owe or increase your tax refund, and some credits may result in a refund even if you don't owe any tax. For instance, some taxpayers can claim a tax credit if they are caring for children or other dependents, which reduces the amount of tax they owe.

Income taxes are collected through withholding (or deducting) money from your paycheck. Employers deduct the money and send it to the government. People who are self-employed, such as entrepreneurs or ride-share drivers, also have to pay income taxes, but those taxes aren't withheld from their earnings. Self-employed people have to pay those taxes on their own. If you are self-employed, make sure that you pay estimated taxes four times throughout the year to avoid a large, tax bill at the end of the year.

*Payroll taxes* are paid by employers and employees. These taxes fund the Social Security program and part of the Medicare program. The employee's amount is withheld (or deducted) from their paychecks. Payroll taxes are referred to FICA on an employee's pay stub. FICA stands for Federal Insurance Contributions Act, the law authorizing the payroll tax for Social Security and Medicare.

People who are self-employed, such as entrepreneurs or ride-share drivers, pay the full amount of their payroll taxes.

To estimate how much money should be deducted from their paychecks for payroll taxes and income taxes, employees complete Form W-4. The Internal Revenue Service (IRS) suggests that people complete a new Form W-4 each year and when their personal or financial situation changes, such as if they get married or have a child.

*Sales tax* is a tax on retail products based on a set percentage of the retail price. People pay this tax when they buy something. State and local governments generally use sales taxes – along with income and property taxes – to pay for state and local public programs.

*Property taxes* are paid on property such as real estate, boats, automobiles, and recreational vehicles.

*Estate taxes and tariffs* are helpful to know about. An estate tax is a tax on the value of property someone owns at their death. This tax is paid only when an estate is worth more than a certain amount. Only a few individuals pay this tax after applying exemptions and other forms of tax credits. A tariff is a tax on products imported from foreign countries. Tariffs can increase the costs of products that are taxed, which ultimately can be passed on to consumers as higher prices.

Taxes also can be progressive or regressive. A progressive tax takes a larger percentage of income from high-income groups than from low-income groups and is based on the concept of ability to pay. A progressive tax system might, for example, tax low-income taxpayers at 10 percent, middle-income taxpayers at 15 percent, and high-income taxpayers at 30 percent. The federal income tax is a progressive tax system. With a regressive tax, everyone pays the same amount or percentage, such as with sales taxes. That may make it seem equitable, but such a tax causes lower-income people to pay a larger share of their income than wealthier people pay.



Download the  
"Understanding paycheck  
deductions" handout to  
learn about how income  
taxes and payroll taxes can  
affect your paycheck.

# What kinds of things do taxes pay for?

Taxes are part of our everyday lives. The three levels of government in the United States – federal, state, and local – each use taxes to pay for public programs.

## Federal taxes

The federal government uses tax dollars to pay for things like national defense, education, health care for the poor, unemployment compensation, benefits such as food stamps and housing subsidies, medical research, transportation, natural resource protection and management, pensions for retired military personnel and government workers, and many other important national expenses.

**Federal payroll taxes:** Social Security and Medicare are among the largest programs that the federal government supports. Funds for these programs come mainly from payroll taxes.

- Social Security provides benefits for retired workers, people with disabilities, and the dependents of both.
- Medicare provides medical benefits for people who are 65 or older, certain younger people with disabilities, and people with permanent kidney failure requiring dialysis or a transplant.

**Other federal taxes:** Income taxes and tariffs are two other types of federal taxes.

| State taxes                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                        | Local taxes                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                        |
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| <p>States use taxes to provide services such as police, road and bridge construction and maintenance, social programs for the poor and elderly, and support for local public-school districts.</p> <p>Taxes vary depending on the state. Most states have an income tax. Some states do not. Many states have sales taxes, and some have property taxes. State property taxes are collected on items such as cars and boats. Some states don't require certain individuals to pay income taxes or sales taxes.</p> | <p>Local governments (such as counties, cities, and towns) use taxes to provide services such as police and fire protection, road and bridge construction and maintenance, and social programs for the poor and elderly. Local taxes also are the primary source of funds for public schools.</p> <p>Taxes vary depending on the local government. A few local governments have an income tax. Many use sales taxes, and some use property taxes. Local property taxes are collected on items such as houses and condominiums.</p> |

## What are some helpful things to know about filing income taxes?

People who work for an employer or work for themselves likely have to file a tax return. Employers report the taxes they withhold (income, Social Security, and Medicare taxes) on Form W-2. Employees use the information on Form W-2 to complete their individual income tax returns. All wages, salaries, bonuses, commissions, and tips are taxable, even if they are not reported on Form W-2.

Self-employed workers don't receive a W-2. Some self-employed people complete work for a company or individual and are considered contractors, not employees of that company or individual. These self-employed people receive Form 1099-NEC and use the income information on that form to complete their tax returns.

Sometimes, young people may think they shouldn't file a tax return because they didn't earn enough money or because they're still supported by their parents or guardians. But many people may lose out on their tax refund simply because they didn't file a federal income tax return. A tax refund is money owed to taxpayers when their total tax payments are greater than the total tax.



You can file your federal income tax return for free. Visit <https://www.irs.gov/filing/free-file-do-your-federal-taxes-for-free> for more information.