



Income Taxes

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- [Background](#)
- [Personal Income Taxes](#)
- [Federal Income Taxes](#)
- [Filing Status](#)
- [State and Local Taxes](#)
- [State Corporate Income Taxes](#)
- [Deductions](#)
- [Credits and Exemptions](#)
- [Reciprocal Personal Income Tax Agreements](#)
- [Additional Resources](#)
- [Organizations](#)

Background

Income [TAXATION](#) has a long history in the United States. During the Civil War, President Lincoln and Congress created the commissioner of Internal Revenue and enacted an [INCOME TAX](#) to pay war expenses in 1862. This first income tax was repealed a decade later. In 1894, Congress attempted to revive the income tax, but the next year the Supreme Court ruled it unconstitutional.

The Sixteenth Amendment to the U.S. Constitution, ratified in 1916, authorized Congress to tax "incomes, from whatever source derived, without [APPORTIONMENT](#) among the several States, and without regard to any [CENSUS](#) or enumeration." That same year, Congress introduced the first form 1040. It levied a 1 percent tax on [NET](#) personal income above \$3,000, and it placed a 6 percent [SURTAX](#) on incomes of more than \$500,000. This top rate of income tax later rose as high as 77 percent as the United States looked for revenues to help finance the World War I effort. World War II ushered in legislation to mandate payroll withholding and quarterly tax payments.

After World War II, the **IRS** was reorganized to replace the patronage system with career, professional employees. As of 2002, only the top IRS official, the IRS commissioner, and the IRS's chief [COUNSEL](#) are selected by the president and confirmed by the Senate.

The Internal Revenue Code (IRC) is contained in Title 26 of the United States Code (26 U.S.C.). This is the body of [STATUTORY](#) law that governs federal income taxation. Congress created the Internal Revenue Service (IRS) to function as the nation's tax collection agency. It administers the IRC. The IRS is a branch of the Department of Treasury, an executive agency. It deals directly with more U.S. citizens than any other public or private institution.

All residents and all citizens of the United States are subject to the federal income tax. Most states also tax the income of their residents, although there are a few states that do not have an income tax. However, not everyone is required to file a return. The general purpose of income tax is to generate revenue for the federal, state, and local budgets. These funds are necessary to shape and preserve the free market economy. Along with individuals, [CORPORATIONS](#) file income tax returns. While they are subject to many of the same rules

as are individual taxpayers, they are also covered by an intricate body of rules addressed to the peculiar nature of corporations.

Personal Income Taxes

While most people automatically think of federal income tax when the subject of personal income tax is raised, not many people know that personal income tax was first introduced by the states. The state of Wisconsin has the dubious distinction of being the first to introduce a form of the personal income tax system in 1911. As of 2002, most states have some form of personal income tax. There are two basic methods to determine income tax, the graduated income tax and the flat rate income tax. Both methods require taxpayers to figure their [TAXABLE INCOME](#).

Federal Income Taxes

The federal income tax is levied on taxable income of U.S. citizens and residents for the taxable year. It also applies to estates, trusts, partnerships, corporation, and other entities. The federal income tax and all other income tax laws, provide for annual returns of income. These are usually remitted to the appropriate department of revenue and cover the preceding [FISCAL](#) or calendar year by the taxpayer or his representative.

There are four main steps to calculating federal income tax. These are:

1. Calculating total income
2. Subtracting deductions
3. Applying the right tax rate to taxable income
4. Subtracting withholding and other payments and credits

Calculating Total Income

A taxpayer's total income can include many kinds of income:

- [ALIMONY](#)
- Amounts received from IRAs and [PENSION](#) plans
- Business and partnership income
- Dividends
- Interest
- Lottery winnings
- Wages
- All other sources of income

The list also includes profit from the sale of stock or real property, otherwise known as capital gain. There are a few sources that are not included, such as gifts and life insurance proceeds.

Subtracting Deductions

After they calculate their deductions and exemptions, taxpayers subtract that amount from their [GROSS INCOME](#). The sum is their taxable income. Deductions reduce taxable income; credits reduce tax. There are four principal types of deductions:

Encyclopedia of Everyday Law: Income Taxes

- **Business deductions:** These are claimed as part of a business's income tax.
- **Adjustments:** These are deductions a taxpayer may claim even if the taxpayer does not claim itemized deductions. Adjustments include alimony and contributions to IRAs or Keogh plans. After subtracting these adjustments from total income, taxpayers arrive at their [ADJUSTED GROSS INCOME](#).
- **Itemized or standard [DEDUCTION](#):** Taxpayers may claim a list of specifically itemized deductions, or taxpayers may take the standard deduction, whichever is larger. There are quite a few things one can add to the list of itemized deductions, including medical expenses, state and local taxes, [MORTGAGE](#) interest, and investment expenses. If taxpayers' itemized deductions do not have a large enough total, the taxpayers may claim the standard deduction instead. The standard deduction depends on filing status; it is adjusted each year for inflation.
- **Exemptions:** Taxpayers get a personal exemption in addition to an exemption for each person who qualifies as the taxpayer's dependent. Like the standard deduction, the exemption deduction is adjusted each year for inflation.

Individuals arrive at taxable income after they subtract these four categories of deductions from their total income.

Applying the Right Tax Rate to Taxable Income

People need to find the tax rate appropriate for them and apply it to their taxable income, the result is their tax. Perhaps the simplest way to do this is to use the tax table supplied with their tax form.

Subtracting Withholding and Other Payments and Credits

The result of this step is the tax owed. This is the place where people learn the amount they owe to the government in additional tax. When individuals overpay their taxes they are entitled to a refund. This is the basic system used by the federal government; it is also the process used in the vast majority of states. In fact, many states require a copy of taxpayers' federal income [TAX RETURN](#) when they file state income tax returns.

Filing Status

Federal income tax is a [PROGRESSIVE TAX](#). This means that the more money earned by taxpayers, the more income taxes taxpayers pay. Taxpayers' filing status is crucial to figuring out their ultimate tax liability.

Filing status is tied to taxpayers' marital status. However, filing status can depend upon when the taxpayer married, when the taxpayer's spouse died, or who else lives in the taxpayer's home. A mistake in determining filing status can be expensive. There are five filing statuses:

1. **Single:** A taxpayer's marital status at the end of the year applies for the entire tax year. If a taxpayer is unmarried on Dec. 31, that taxpayer generally must file as a single person for that year.
2. **Married filing jointly:** If a taxpayer is married at end of the year, the taxpayer can file a joint return with his or her spouse. The taxpayer may also file under the status of married filing separately. The latter status requires preparing two 1040s (one for each spouse).
3. **Married filing separately:** Married people are not absolutely required to file a joint return with their spouses. Instead, they have the option to file separate income tax returns, with each return listing that spouse's share of the couple's income and deductions. This can be advantageous for some couples, though most find it the least advantageous way to file. And state laws also affect the bottom line. For example, in some states, a married couple's income is deemed by law to be split 50/50; this is true

regardless of who actually earns the income. In other words, the laws of a state may make it unattractive to file separate federal returns.

4. Qualifying widow/widower: If taxpayers' spouses die, they may be able to continue to file under the status of married filing jointly for up to two years after the spouse's death. The taxpayer must remain single during those two years. Additionally, the taxpayer must pay over half the cost of maintaining a home for a dependent child. After the initial two years, such taxpayers may qualify to file as [HEAD OF HOUSEHOLD](#).
5. Head of household: Generally a taxpayer must be single to file as a head of household (HOH). A taxpayer who qualifies for this status is entitled to more favorable tax brackets and a more generous standard deduction. A taxpayer can claim HOH status if the taxpayer is single and pays over half the cost of maintaining the principal home for the taxpayer and another relative who lives with the taxpayer over half the year and can be claimed as a dependent on the taxpayer's return. The only exception to the general rule that a taxpayer must be single to be a HOH is the "abandoned spouse rule." A taxpayer may qualify for HOH if the individual was married at the end of the year and lived with the taxpayer's child but apart from the person's spouse for at least the last half of the year.

In addition to federal income tax, most individuals must pay state income tax, and in some cases local income tax, depending on their place of residence. Besides the various income taxes, employers are required to withhold 6.2 percent of their employees' income for Social Security and another 1.45 percent for MEDICARE. Individuals with J, F, M and Q visas are exempt from Social Security and Medicare withholdings.

State and Local Taxes

In the United States, individual states have maintained their right to levy taxes, and the federal government has always recognized this right. When the U.S. Constitution was ratified, the federal government was also granted the power to levy taxes. The right to impose taxes—except those taxes that are expressly forbidden by the Constitution and their own state constitutions—was retained by the states. In addition to money from the federal government, the fifty states get the money they need to provide essential services through taxes, fees, and licenses.

Some of the most common types of taxes imposed by states include:

- [CORPORATE](#) income tax
- Personal income tax
- Real and [PERSONAL PROPERTY](#) tax
- [SALES TAX](#)

In the 1930s and 1940s, personal income tax and sales tax were introduced in many states. The depression prompted the need for new ways for states to bring in additional revenue to finance public services.

Unlike personal income taxes, the tax on real property has a very long history in the United States. As early as 1646, the Massachusetts Bay Colony taxed settlers who owned land. After independence, many states introduced new systems of property taxes. Eventually, local governing bodies assumed the power to tax property. Property tax is generally paid to a local government, a school district, a county government, or a water district, but not to a state or the federal government.

State individual income taxes generally apply to all natural persons as individuals, partners, fiduciaries and beneficiaries. Most states use a system of graduated tax rates, but six states have a flat rate tax. They are:

1. COLORADO
2. ILLINOIS
3. INDIANA
4. MASSACHUSETTS
5. MICHIGAN
6. PENNSYLVANIA

Taxpayers conducting business as partnerships are liable for income tax only in that taxpayers' individual capacity, but the taxpayers must report partnership income they received. Estates and trusts are taxed in much the same way as individuals. Basically, the entire income of an estate or trust must be reported on a return filed for it by the [FIDUCIARY](#) (the personal representative of the estate or the trustee(s) of a trust).

There are few constitutional limits to a state's power to tax net income of its residents. In fact, most states impose a variety of taxes upon their residents, as well as those conducting business within their borders. In most states, individual residents are taxed on their entire net incomes. There are seven states that do not collect individual income taxes. They are:

1. ALASKA
2. FLORIDA
3. NEVADA
4. SOUTH DAKOTA
5. TENNESSEE
6. TEXAS
7. WASHINGTON
8. WYOMING

Nonresidents are taxed on their net income earned from property located or business carried on in the state.

State Corporate Income Taxes

Most states impose a corporate income tax in addition to personal income tax. This makes corporations subject to income tax in the same way as individuals although rates, deductions, and other important rules differ between individuals and corporations. Some state corporate income tax systems use a graduated method, and some states use a flat rate method. To help attract businesses to their states, some states purposely keep their corporate income tax rates lower than other states. Other incentives can include certain tax exemptions, also designed to attract new businesses to these states.

Deductions

Individual taxpayers may claim deductions for alimony, medical expenses, dividends from income otherwise taxed, and charitable contributions or gifts. Many states allow an optional standard deduction in lieu of other deductions, much like the federal option for standard or itemized deductions. But states seldom offer this option in lieu of business expenses; this deduction is a percentage of gross or adjusted gross income. There is no state deduction for personal, living, or family expenses.

Credits and Exemptions

Several state personal income tax laws allow taxpayers to deduct certain amounts of money from their net income according to filing status: single, heads of families, and individuals with dependents. And a few states permit the taxpayer to take the personal exemption in the form of a credit against the tax.

While there are some limitations, residents of states with income taxes are usually permitted to take a credit for taxes paid on income paid to another state. The tax must arise from personal services or business carried on in the other state. In terms of income earned in the state, nonresidents are often given a credit for taxes paid to their state of residence.

Reciprocal Personal Income Tax Agreements

Several states have adopted income tax reciprocity agreements with one or more sister states— including the District of Columbia. These agreements allow income to be taxed in the state of residence even though it is earned in another state, as long as the state where the income was earned is a party to the reciprocity agreement. Such reciprocity agreements are an exception to the rule stating that the state in which income is earned has the primary right to tax that income.

In addition to reducing administrative reporting burdens, states with these agreements do not anticipate significant revenue loss because of them. Even considering the number of nonresidents working in a given state, its tax rate, and taxpayer income levels, the taxable revenue shared between the states may be about the same in both states.

Generally, reciprocal agreements only cover compensation, such as wages, salaries, tips, commissions, and bonuses a taxpayer receives for personal and professional services. But states may specify that certain income, such as lottery winnings, is not covered under reciprocity agreements.

Reciprocity agreements can simplify tax filing for some taxpayers. But in general, U.S. tax laws are very complicated. Fortunately, there are inexpensive tax preparation programs that people can use to make the annual tax filing chore easier. Taxpayers may also consult experienced tax professionals or attorneys for in-depth answers to more complex issues or for other specific tax advice.

Additional Resources

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Organizations

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