**Income tax** is typically charged by federal, state, and/or local governments and is based on the income earned by an individual each calendar year. Each worker must file specific tax returns each year with federal, state, and local governments to show how much income they earned and how much income tax they must pay. Most people do not pay taxes on every dollar earned because of special rules that apply to taxpayers based on certain conditions. **Tax exemptions** and **tax deductions** both reduce your tax liability by lowering your taxable income.

**Exemptions** relate to your filing status and to the number of dependents you have. The Internal Revenue Service (IRS) offers two types of exemptions: **personal** and **dependent**. For the 2016 tax year the **personal exemption** and **dependent exemption** are$4,050 per person. In general, the more people in your household, the lower your taxable income.

**Deductions** are related to expenses you have paid during the tax year that are subtracted from your gross income to reduce the amount of income subject to income tax. In general, the greater your qualified expenses, the lower your taxable income. For example, if you earn $40,000 and claim a deduction of $1,000, then your taxable income is reduced to $39,000.

Federal laws also allow taxpayers to deduct what they paid for **state taxes**, **property taxes**, **mortgage interest**, and **charitable contributions**. In order to take these deductions, the family must complete a special form where their **itemized deductions** are totaled and then off set against income earned.

***Smith family: two working parents, three children ages 2-14***

$102,000 total family income for 2016

$8,000 of mortgage interest on $100,000 mortgage

$1,500 of property taxes

$3,800 of state taxes

$700 of charitable contributions

**Step 1: Determine the Smith family’s total exemptions and deductions:**

|  |  |
| --- | --- |
| Exemption/Deduction Title | Exemption/Deduction Amount |
|  |  |
|  |  |
|  |  |
|  |  |
|  |  |
|  |  |
|  |  |
|  |  |
| Total Exemptions/Deductions |  |

Once taxpayers have determined all of their exemptions and deductions, they can calculate their **taxable income**. This is done by subtracting the total amount of exemptions and deductions from their **gross income**.

**Step 2: Determine the Smith family’s taxable income:**

|  |  |
| --- | --- |
| Gross Income |  |
| - exemptions and deductions: |  |
| Taxable Income |  |

The government uses various tax rates to assess taxes on taxable income. The higher the taxable income, the higher the tax rate. This is called a **progressive tax** schedule. Examples of how these rates can vary are shown below (2016 rules for married filing jointly taxpayers):

|  |  |
| --- | --- |
| **Taxable Income** | **Tax Rate** |
| $0—$18,550 |  10% |
| $18,551—$75,300 |  $1,855 plus 15% of the amount over $18,550 |
| $75,301—$151,900 |  $10,367.50 plus 25% of the amount over $75,300 |
| $151,901—$231,450 |  $29,517.50 plus 28% of the amount over $151,900 |
| $231,451—$413,350 |  $51,791.50 plus 33% of the amount over $231,450 |
| $413,351—$466,950 |  $111,818.50 plus 35% of the amount over $413,350 |
| $466,951 or more |  $130,578.50 plus 39.6% of the amount over $466,950 |

**Step 3: Determine the Smith family’s total income tax:**

Using the taxable income you calculated earlier, determine how much the family’s total income tax will be using the tax rates listed above.

|  |  |
| --- | --- |
| Taxable Income |  |
| Tax Amount |  |

**Tax Credit**

A **tax credit** is an amount of money a taxpayer is able to subtract from taxes owed. The value of a tax credit depends on the nature of the credit, and certain types of tax credits are granted to individuals or businesses in specific locations, classifications or industries. Unlike **deductions** and **exemptions**, which reduce the amount of taxable income, **tax credits** reduce the actual amount of tax owed.

You may be able to reduce your federal income tax by up to $1,000 for each qualifying child with a **child tax credit**. A qualifying child for this credit must be your son, daughter, stepchild, foster child, brother, sister, stepbrother, stepsister or a descendant of any of these individuals, which includes your grandchild, niece, or nephew. An adopted child includes a child lawfully placed with you for legal adoption and is always treated as your own child. The child must be a U.S. citizen, U.S. national, or U.S. resident alien who was aged 16 or younger at the end of 2016. The child have lived with you for more than half of 2016 and must not have provided more than half of their own support. You must claim the child as a dependent on your federal tax return. The credit is limited if your modified adjusted gross income is above a certain amount. For married taxpayers filing jointly, the phase-out begins at $110,000 of gross income. For married taxpayers filing a separate return, it begins at $55,000. For all other taxpayers, the phase-out begins at $75,000.

**Step 4: Determine the Smith family’s child tax credit(s):**

|  |  |
| --- | --- |
| Tax Amount |  |
| - Child Tax Credit(s) |  |
| Adjusted Tax Amount |  |