Income taxes explained in 7 simple concepts

Employees file their W-4s and then forget about them. Whether they know it or not, when you withhold employees' income taxes based on those W-4s, you're introducing them to the wacky world of individual income taxation. This world has its own language and, like any foreign language, most people find it confoundingly difficult to understand.

Each of the following income tax terms has an impact on employees' withholding. Employees don't need an advanced degree in taxation, but they should know the basics. This way, they can look after their own withholding and make adjustments as needed, instead of complaining to you.

Total (gross) income

Total income is the broadest measure of income. It's all taxable income recognized by the Internal Revenue Code. It includes wages, salaries and tips; interest and dividends; capital gains; and pensions and annuities. Gross income doesn't include income excluded from tax. *Examples:* employer contributions for health insurance and to retirement benefits.

For withholding purposes: Employees' taxes are based on more than what they earn and have withheld. Employees, therefore, should take all income sources into consideration when they complete or adjust their W-4s.

Adjustments to income (above-the-line deductions)

Adjustments to income, also called above-the-line deductions, are allowed for some payments. *Examples:* contributions to IRAs and forfeited penalties on early withdrawals of savings and interest paid on student loans.

Adjustments to income are similar to itemized deductions because they reduce total taxable income. Unlike itemized deductions, above-the-line deductions are generally claimed by all qualified taxpayers, regardless of whether they use the standard deduction or itemize.

For withholding purposes: Adjustments to income raise or lower employees' total income and result in adjusted gross income. Adjustments to income also need to be accounted for when employees complete or adjust their W-4s.

Taxable income

Taxable income is the narrowest measure of income. It equals adjusted gross income minus the standard deduction or itemized deductions.

For withholding purposes: Taxable income is the base on which the tax rates are applied to calculate income tax liability.

7600 Leesburg Pike, Suite 300, Falls Church, VA 22043-2004 (800) 543-2002

Tax liability

Tax liability is your gross taxes before tax credits are subtracted. Most taxpayers' gross tax liability equals their regular income tax liability, which is calculated by applying the marginal tax rate schedule to their taxable income.

For withholding purposes: The tax rate schedules and the withholding tables don't match up. However, both tables apply marginal tax rates.

- In the withholding tables, if you're a single taxpayer with $65,000 in annual taxable income, your marginal tax rate is 22% on income exceeding $46,125.
- In the income tax tables, if you're a single taxpayer with $65,000 in annual taxable income, your marginal tax rate is 22% on income exceeding $41,775.

Nonrefundable credits

Nonrefundable tax credits are subtracted from your gross tax liability to arrive at your final tax liability. Nonrefundable tax credits reduce your tax liability on a dollar-for-dollar basis. Nonrefundable credits may reduce your liability to $0, but not below $0. *Examples*: the credit for child and dependent care expenses.

For withholding purposes: In general, employees must reduce the income they take into account for figuring the nonrefundable dependent care credit by the amount of any employer-provided dependent care assistance benefit.

Refundable credits (payments)

Refundable tax credits are payments. Unlike nonrefundable tax credits, refundable tax credits can exceed your tax liability. When they do, you get a tax refund.

For withholding purposes: Employees' withholding during the year, as recorded on their W-2s, is a refundable tax credit. If their withholding exceeds their tax liability, they get tax refunds. If it doesn't, they pay the difference to the U.S. Treasury.

Exemption from withholding

Employees may opt out of withholding, but not their tax liability, by filing W-4s on which they write "Exempt" underneath Line 4(c).

Technically, employees may claim an exemption from withholding if they owed no income taxes last year and anticipate owing no taxes this year. In other words, all the taxes they had withheld from their pay last year were refunded to them. Employees who just get tax refunds representing a partial tax overpayment shouldn't be claiming exempt on their W-4s.

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