TAXES 101

Whiz-Bang Tax Glossary... More Fun to Read Than You Can Imagine

Much of tax discussion depends on understanding terminology, most of which is unclear except to those who benefit most and their tax advisors. For more late night reading you can flip through the IRS instruction pamphlets or visit their website. Some of the most important tax terms are:

Alternative Minimum Tax
The alternative minimum tax is not a distinct tax, but a kind of parallel tax calculation first enacted in 1969 and intended to prevent upper-income individuals from sharply reducing, even eliminating, federal personal income tax liabilities. It requires a separate computation from the usual tax calculations to determine if a taxpayer is liable under the AMT. In 2000 the AMT affected about 1 percent of US tax returns, but by 2010 it is estimated to affect about one-third of all taxpayers unless it is changed. This arises primarily because, unlike tax brackets in the regular personal income tax, **tax brackets** for calculating the AMT are not routinely adjusted for inflation. Because of these effects, there will be strong political pressure to change the AMT. Such changes will strongly affect estimates of future national government revenues, which now assume the AMT will expand and so increase the amount of revenue.

Consumption Tax
A consumption tax is based on the amount consumed rather than the amount earned. It is administered in various ways. The simplest way of calculating this tax allows an individual taxpayer to subtract savings from income. The difference is consumption, which is the amount or base on which the tax is calculated. Most consumption tax proposals are more complicated. An argument for consumption taxes is that they encourage and reward saving and investment. A frequent criticism of consumption taxes is that upper-income individuals are able to save more than those lower in the income scale, so a consumption tax can be **regressive**, depending on rate structure. Sales taxes and **value added taxes** (VAT) are forms of consumption tax.

Effective Tax Rate
The percentage of total income actually taxed. An important reason that effective tax rates are below nominal tax rates is that the various "chunks," or brackets, of a person's taxable income are taxed at different rates under the federal personal income tax. During the 2004 tax year, the first $7,150 of a single person's taxable income was taxed at 10 percent; the amount over $7,150 but below $29,050 was taxed at 15 percent; over $29,050 but below $70,350 was taxed at 25 percent; and so on. (The bracket cut-off points are changed each year to keep up with inflation and to avoid being pushed into higher tax brackets by inflation alone, not by real pay increases.) A person's total tax is determined by adding together the taxes paid on each "chunk" of income. **Very few people know this**, partly because tax tables, tax calculation software, and tax preparers do all of the arithmetic, inadvertently hiding the different tax rates that exist for different brackets (or chunks) of taxable income.

Flat Tax
A system under which all income levels are taxed at the same rate. Please see the sidebar Flat Tax in this section because no so-called "flat tax" is totally "flat." Many flat tax proposals exclude from taxation much of what is now considered taxable income.

Marginal Tax Rate
The rate of tax at a particular **tax bracket**. We pay a graduated rate on the portions of our income that are in different brackets, as described under **Effective Tax Rate**.

Nominal Tax Rate
The tax rate on the highest "chunk" of a person's income.

Non-Refundable Tax Credit
Allows use of a **tax credit** only up to the amount of tax owed. A non-refundable tax credit, say of $1000 per child, would be worth more to high income people—who owe more in income taxes—but might not be helpful at all to those with lower incomes and therefore lower taxes.

Progressive Tax
Means that the percent (not just amount) paid in taxes increases as income increases. For example, if $10,000 is taxed at 10 percent and $100,000 taxed at 25 percent, the tax is progressive. Proportional taxes are those in which the percent paid in taxes stays the same as income increases; some state and local tax systems are nearly proportional though most are at least somewhat **regressive**. The national government personal income tax is the clearest example of a progressive tax.

Refundable Tax Credit
Allows a taxpayer to receive the full amount of the credit, even if the tax owed is less than the amount of the credit. The national earned income tax credit (EITC) is refundable, and, as a result, it is considered by many policy makers to be the single most important anti-poverty measure for the working poor.

Regressive Tax
Means that the percent paid in taxes falls as income increases, even though the dollar amount paid in taxes may increase. People also use this term to describe the affect of making taxes less **progressive**. For example sales taxes and property taxes without rebates or credits for people in lower income brackets usually produce regressive taxes.

Retail Sales Tax
Often called simply a "sales tax," a retail sales tax is applied to items purchased. Most states use the (retail) sales tax and these can have a number of variations. Many states exclude items, most commonly food purchased in grocery stores and medicines. Sales taxes on specific items, for example tires or telephone calls, are called excise taxes, and have been used by both national and state levels of government in the United States.

Social Insurance Taxes
Social insurance taxes (usually called "contributions") are the money collected to fund Social Security and Medicare. They are shown separately on pay checks as withholdings to income and are dedicated to fund those programs; surpluses in excess of amounts distributed in any year are invested in national government bonds and other securities, where they draw interest that is added to the trust funds (in this way these funds are a source of revenue for financing the federal debt). Note that nearly all federal tax changes in recent years have reduced personal income taxes but not social insurance taxes. These taxes are more **regressive** than federal income taxes.

Tax Base
This identifies what is taxed and what is not taxed. Broadening the tax base produces more tax revenue, even if tax rates are not changed, and narrowing produces less.

Tax Bracket
Indicates the percent of income paid in tax on the highest dollar of taxable income, such as the "15 percent bracket" or the "35 percent bracket." Adding up the tax obligation for each "chunk" of income, or tax bracket, determines the total tax paid. The **effective tax** rate is calculated by dividing a person's total tax into the total income.

Tax Credit
Usually a direct reduction in taxes paid. As a result, a tax credit of $1000 potentially reduces the amount of taxes paid by all taxpayers equally, regardless of income level.

Tax Deduction
Reduces the income on which taxes are based. (A tax exemption works the same way.) As a result, a deduction is worth the most in the highest tax brackets. For example, in the federal personal income tax, a deduction of $1000 reduces taxes by $350 dollars for those who have $1,000 of income in the highest tax bracket (35% of $1,000) but by only $100 dollars (10% of $1000) for those in the lowest **tax bracket**.

Value Added Tax (VAT)
The value added tax is charged on each stage of the production process, but is collected on the final point of sale. Although it resembles a "sales tax," it is thought to be easier to administer, especially at very high rates. In reality such taxes in Europe and elsewhere have become very complex, so have lost some of their administrative ease. Most nations of the world, except the United States, use VAT for a significant share of their national government revenue. Many economists argue that VAT is essentially a kind of **consumption tax**. In the early 1990s the US government considered instituting a VAT to fund national healthcare programs.