NETWORK

ADVOCATES FOR JUSTICE, INSPIRED BY CATHOLIC SISTERS

Tax Justice for All: Tax Terms Explained

This handout is part of a broader workshop, *Tax Justice for All: Unveiling the Racial Inequities of the U.S. Tax Code*. To find out about future opportunities to participate in the workshop visit http://www.networklobby.org/events. To invite us to give this workshop to your group, visit www.networklobby.org/inviteus. For other questions, please email info@networklobby.org.

Progressive Taxation: A system that charges *progressively* higher tax rates on higher incomes, as opposed to a flat tax that applies the same rate to all incomes. The rationale is that, compared to lower-income people, higher-income people have more *excess income* left over after paying for necessities like food, clothing and shelter. By taking the same share from every household regardless of income, a flat tax *leaves poorer households with less excess income* that richer ones. Progressive taxation avoids that injustice.

Tax Rates: Federal income tax rates are applied to segments (brackets) of income rather than to the total amount. The taxes due on each bracket are then added together to find the total tax due. The same rates apply to the same brackets of each taxpayer's income, no matter how high or low the total income.

For example: in 2021 the first roughly $10,000 of an individual's earned taxable income is taxed at 10%, whether made by an Amazon warehouse worker or Amazon's billionaire founder, Jeff Bezos. The next $30,000 or so earned by anyone is taxed at 12%, and the next roughly $45,000 at 22%.

The ***effective tax rate*** is the share of income paid once all the taxes on individual brackets are totaled. For an individual with, as in the example above, $85,000 ($10,000+$30,000+$45,000) in earned taxable income, the 10% tax on the first $10,000 equals $1,000; the 12% tax on the next $30,000 equals $3,600; the 22% tax on the final $45,000 equals $9,900. The three dollar amounts total $14,500 ($1,000 +$3,600+$9,900), which is about 17% of the $85,000 total income. So this taxpayer's *effective tax rate* is 17%.

The ***marginal tax rate*** is the rate paid on the highest bracket of income—the one on the upper *margin* of all the brackets—in this case, 22%. Marginal tax rates are important for anticipating the likely impact of tax-rate changes on taxpayer behavior, since the marginal rate is the one that will be paid on the next dollar earned.

Tax Deduction: A subtraction from reported income before figuring tax. By reducing the amount of reported income, deductions reduce taxes due. Deductions are meant to compensate for expenses incurred from misfortune, like out-of-pocket healthcare costs (medical expense deduction), or from pursuing a socially desirable goal like home ownership (mortgage interest deduction). There are two types of federal income tax deductions.

The ***standard deduction*** is an estimate by the government of how much a typical taxpayer pays each year in such deductible expenses. Taxpayers who take the standard deduction do not need to document or otherwise prove they have actually incurred that much expense. For that reason and because the standard deduction is generous (in 2021, over $12,500 for individual filers and over $25,000 for married filers—and the figures rise each year with inflation), roughly 85% of taxpayers take the standard deduction.

Taxpayers who claim ***itemized deductions*** must document they actually paid those expenses, which is generally worth it if the total exceeds the standard deduction. Only the 10% highest-income taxpayers are likely to claim itemized deductions.

Deductions are more valuable the higher the tax rate. For someone paying a marginal tax rate of 22%, a $1,000 deduction saves $220 in taxes (22% x $1,000). For someone paying a 37% marginal tax rate, the same $1,000 deduction saves $370 in taxes (37% X $1,000).

Mortgage Interest Deduction: Homeowners who itemize deductions may reduce their taxable income by deducting interest paid on a home mortgage. Taxpayers who do not own their homes have no comparable ability to deduct their rent or the interest paid on loans to purchase other goods like cars.

Tax Credit: A taxpayer expense directly subtracted from tax liability (as opposed to a reduction in the *amount of income being taxed*—see "Tax Deduction"). Credits are generally allowed for costs paid in pursuit of socially desirable goals, like staying employed despite low wages (Earned Income Tax Credit), affordable childcare (childcare credit), and a cleaner environment (renewable energy credits). Example: if the amount of tax due is figured at $10,000 before the application of any credits, a $1,000 tax credit would reduce the tax bill to $9,000. Tax credits vary by the amount that can be refunded:

A ***refundable tax credit*** can exceed the tax otherwise due, resulting in a refund to the taxpayer. Refundable tax credits can even be applied if no tax is due, meaning the entire credit becomes a refund. Examples: if the tax due before credits is $4,000 and a $5,000 refundable credit is applied, the taxpayer gets a $1,000 refund ($4,000 - $5,000). If no tax is due, the taxpayer gets the full $5,000 as a refund.

A ***nonrefundable tax credit*** cannot be used to lower tax liability below zero. Example: if the tax due before credits is $4,000 and a nonrefundable credit of $5,000 is applied, the tax bill is reduced to zero but the excess $1,000 is not sent to the taxpayer as a refund.

A ***partially refundable tax credit*** allows a part of the credit to be refunded but not all.

Earned Income Tax Credit (EITC): A refundable tax credit that's meant to make low-wage work pay by supplementing the earnings of low-income workers. The credit value is based on the amount of wage income and number of children in the household (up to three). In 2020, a childless worker was eligible for some amount of credit if her wage income was below $15,820; a couple with three kids could earn almost $57,000 and still be eligible for the EITC.

Child Tax Credit (CTC): A tax credit given to parents with minor dependent children. The American Rescue Plan (ARP) has temporarily made the credit more generous for most families and changed how it is refunded. Democrats want to make these changes permanent.

For 2021, the credit has been raised for married couples making less than $150,000 ($112,500 for single parents) to $3,000 for each child between ages 6 and 17 and $3,600 for each child under age 6. Between that income threshold and $182,000 ($144,500 for singles), the credit amount phases down till it reaches the amount in place prior to the ARP enhancement: $2,000 per minor child of any age. Married couples continue to be eligible for the $2,000 credit till their income reaches $400,000 (singles till $200,000), at which point the credit again phases down till it reaches zero at an income of $440,000 ($240,000 for singles).

Before the ARP, the CTC was only partially refundable, which denied all or part of the credit to some of the poorest families. The ARP made the credit fully refundable. It also changed how refundable amounts are distributed: instead of waiting to receive their entire 2021 CTC refund only after filing their tax returns next spring, families receive half of the estimated (based on prior year filings) credit divided into six equal monthly payments in the second half of 2021.

Capital Gains: A capital gain is the increase of an asset value over its purchase price. Example: if you buy an investment for $100 and later sell it for $150, you have a capital gain of $50 ($150 sales price minus $100 purchase price). Gains made on assets owned more than a year are known as "long-term"; less than a year, "short-term." High-income taxpayers get most of the income from long-term capital gains and a related form of investment income known as dividends:

- 88% goes to the highest-income 10%—those making at least $240,000 a year.
- 75% goes to the highest-income 1%, who make at least $819,000.
- 55% goes to the highest-income 0.1%, who make at least $3.8 million.

Capital Gains Taxes: Long-term capital gains are taxed at a lower rate than so-called "ordinary income," which includes wages, salaries, interest, rental income, even short-term capital gains. The top basic tax rate on long-term capital gains is 20% while the top basic rate on wage and other ordinary income is 37%. Capital gains were taxed at the same rate as ordinary income for several years following the landmark tax reform of 1986, but were afforded a discount rate again beginning in 1990.

In 2021, an unmarried middle-income worker like a teacher or truck driver will pay 22% of income tax on every dollar of taxable salary she makes over $40,525. A billionaire living entirely off long-term capital gains or dividends will pay no more than 20% on his millions of dollars of unearned income.

Step Up in Basis: If the owner of an investment that's gone up in value dies before selling it, neither the owner or his or her heirs will owe any tax on that gain. That increase in value simply disappears for tax purposes. This reset of the base price of the investment is called valuation "step up." The inheritor is only responsible for any gains that occur after the inheritance (and again, the heirs would only pay tax on the gain during their lifetime if they sold the asset – they could also avoid tax by passing assets onto their heirs).

Example: Jeff Bezos' wealth, which is largely derived from his ownership stake in Amazon, has soared from nothing to nearly $200 billion over the last 25 years or so. Under current rules, if he sells his Amazon stock the day before he dies he would have made a capital gain on most of that wealth and a 20% capital gains tax would be due. Instead, if his estate passes the stock onto his children and they sell it the day after Bezos dies, they would owe zero tax on the nearly $200 billion in capital gains— avoiding the more than $40 billion of tax that would apply at today's lower capital gains rates or the roughly $80 billion that would apply if they paid tax at ordinary rates. This tax handout to rich inheritors helps create undemocratic economic dynasties, widens the nation's destabilizing wealth gap, and creates a drag on the economy because people hold unproductive assets until death to avoid taxation.

Pass-Through Business: 95% of American businesses are so-called "pass-through" entities: sole proprietorships, partnerships, and S corporations. Unlike famous companies like Amazon and General Motors, these entities do not pay the corporate income tax. Instead, profits and losses are passed through to the individuals who own the business, who pay any tax due on their personal returns at individual rates. Pass-through businesses run the gamut from corner groceries and independent web designers to billion-dollar real estate developers and high-priced law firms. But even though the business form is broadly shared among different-sized companies, the income flowing to them is not: half of all pass-through income goes to the wealthiest 1% of business owners.

Pass-Through Business Deduction: Owners of pass-through businesses are allowed, with several restrictions, to exclude 20% of their business income from taxation. This effectively lowers the top tax rate to as low as 29.6%—7.4 percentage points below the 37% top marginal tax rate for the highest-earning employees. It has been projected that three-fifths of the value of this tax break, supposedly targeted at "small businesses," will go to the richest 1% of business owners by 2024. Initial data from the JCT shows that two-thirds (66%) of this tax break is accruing to those with household income above $315,000 for joint filers.

That's why it's misleading to call this tax break, as its proponents do, a "small business tax cut." Moreover, any benefit from a pass-through tax cut or other tax advantage may be greatly outweighed by the loss of public services—whether small business loans, infrastructure repair, and income-support programs for their customers—that such tax cuts could necessitate to meet budget goals.

Carried Interest Loophole: Wealthy investment managers of private equity, real estate and hedge funds are allowed to pay the discounted capital-gains tax rate, and avoid payroll taxes, on so-called "carried interest": earnings tied to a percentage of the fund's profits. But this income is actually employment compensation for managing other people's investments. Therefore, it should be taxed at the same rate as wages and salaries and be subject to the self-employment tax. Income that fund managers receive as a return on their own capital contribution would continue to enjoy the appropriate capital-gains discount (assuming such a discount was still in effect).

820 First Street NE, Suite 350, Washington, DC 20002 | 202-347-9797
info@networklobby.org | networklobby.org | networkadvocates.org
facebook.com/NETWORKLobby | twitter.com/@NETWORKLobby

Joint Filing Bonus/Marriage Bonus: An implicit tax bonus received by couples who have substantially different incomes and file taxes jointly. This happens because joint filing doubles the size of the tax brackets, effectively averaging the incomes of each spouse and lowering the marginal tax rate they're eligible for.

Marriage Penalty: The additional tax that some married couples pay because they must file as married rather than as single filers. Marriage penalties result from the combination of treating a family as a single tax unit and progressive tax rates. In general, couples in which spouses have similar incomes incur marriage penalties.

Imputed Income: This refers to the amount of money some families save by having one parent able to take full-time responsibility for household tasks that may otherwise be outsourced (childcare, etc.). Imputed income cannot be measured and is not taxed.

Employer-Based Health Care: Employer-paid premiums for health insurance are exempt from federal income and payroll taxes. Additionally, a portion of premiums employees pay is typically excluded from taxable income. The exclusion of premiums lowers most workers' tax bills and thus reduces their after-tax cost of coverage. This tax subsidy partly explains why most American families have health insurance coverage through their employers. (The exclusion from tax of employer-sponsored health insurance is the single biggest tax expenditure.)

Home Equity Increase: Taxpayers who sell assets must generally pay capital gains tax on any profits made on the sale. But homeowners may exclude from taxable income up to $250,000 ($500,000 for joint filers) of capital gains on the sale of their homes if they satisfy certain criteria.

Student Loan Interest Deduction: The student loan interest deduction allows taxpayers with qualified student loans (loans taken out solely to pay qualified higher education expenses) to reduce taxable income by $2,500 or the interest paid during the year, whichever is less.

529 Accounts: A tax-advantaged savings account designed to be used for the beneficiary's education expenses, including college education, K-12 tuition, certain apprenticeship costs, and student loan repayment. Anyone, regardless of income, may contribute tax-free (up to $15,000 annually or $75,000 on behalf of a five-year period, per person) to a 529 plan for a designated beneficiary. Money in 529 Accounts can be invested and increase in value tax-free.

Social Security Tax Cap: Up to $137,700 in wages is subject to FICA taxes, a threshold updated for average wage growth each year. Higher wage earners are not subject to those taxes.

Employer-Based Retirement Plan: Defined-benefit plans generally distribute funds regularly to retired employees according to formulas that reflect employees' years of work and earnings. In defined-contribution plans, of which the 401(k) plan is the most common, balances depend on past employee and employer contributions and on the investment returns accumulated on those contributions. Employers are not required to offer their employees retirement benefits, and only about half of all workers were covered by an employer-sponsored plan in tax year 2016.

820 First Street NE, Suite 350, Washington, DC 20002 | 202-347-9797
info@networklobby.org | networklobby.org | networkadvocates.org
facebook.com/NETWORKLobby | twitter.com/@NETWORKLobby