

Taxes: Understanding the basics

What are taxes?

Taxes are required payments of money to governments, which use the funds to provide public goods and services for the benefit of the community as a whole. Understanding taxes is an important part of managing your money, both now and in the future.



What types of taxes are there?

Common types of taxes include income, payroll, sales, and property taxes.

Income taxes are federal, state, and local taxes that may be collected on income, both earned (salaries, wages, tips, commissions) and unearned (interest, dividends). Most of the federal government's revenue, or money it receives, comes from income taxes. Not all states and localities have income taxes, and the government may not collect income tax if your income is below a set amount.

You can change the amount of income tax you owe by claiming tax credits and deductions on your tax return:

- A tax deduction is an amount (often a personal or business expense) that reduces income subject to tax.
- A tax credit is a dollar-for-dollar reduction in a tax. It can be deducted directly from taxes owed. Tax credits can reduce the amount of tax you owe or increase your tax refund, and some credits may result in a refund even if you don't owe any tax. For instance, some taxpayers can claim a tax credit if they are caring for children or other dependents, which reduces the amount of tax they owe.

Income taxes are collected through withholding (or deducting) money from your paycheck. Employers deduct the money and send it to the government. People who are self-employed, such as entrepreneurs or ride-share drivers, also have to pay income taxes, but those taxes aren't withheld from their earnings. Self-employed people have to pay those taxes on their own. If you are self-employed, make sure that you pay estimated taxes four times throughout the year to avoid a large, tax bill at the end of the year.

Payroll taxes are paid by employers and employees. These taxes fund the Social Security program and part of the Medicare program. The employee's amount is withheld (or deducted) from their paychecks. Payroll taxes are referred to FICA on an employee's pay stub. FICA stands for Federal Insurance Contributions Act, the law authorizing the payroll tax for Social Security and Medicare.

People who are self-employed, such as entrepreneurs or ride-share drivers, pay the full amount of their payroll taxes.

To estimate how much money should be deducted from their paychecks for payroll taxes and income taxes, employees complete Form W-4. The Internal Revenue Service (IRS) suggests that people complete a new Form W-4 each year and when their personal or financial situation changes, such as if they get married or have a child.

Sales tax is a tax on retail products based on a set percentage of the retail price. People pay this tax when they buy something. State and local governments generally use sales taxes – along with income and property taxes – to pay for state and local public programs.

Property taxes are paid on property such as real estate, boats, automobiles, and recreational vehicles.

Estate taxes and tariffs are helpful to know about. An estate tax is a tax on the value of property someone owns at their death. This tax is paid only when an estate is worth more than a certain amount. Only a few individuals pay this tax after applying exemptions and other forms of tax credits. A tariff is a tax on products imported from foreign countries. Tariffs can increase the costs of products that are taxed, which ultimately can be passed on to consumers as higher prices.

Taxes also can be progressive or regressive. A progressive tax takes a larger percentage of income from high-income groups than from low-income groups and is based on the concept of ability to pay. A progressive tax system might, for example, tax low-income taxpayers at 10 percent, middle-income taxpayers at 15 percent, and high-income taxpayers at 30 percent. The federal income tax is a progressive tax system. With a regressive tax, everyone pays the same amount or percentage, such as with sales taxes. That may make it seem equitable, but such a tax causes lower-income people to pay a larger share of their income than wealthier people pay.



Download the
“Understanding paycheck deductions”
handout to
learn about how income
taxes and payroll taxes can
affect your paycheck.

What kinds of things do taxes pay for?

Taxes are part of our everyday lives. The three levels of government in the United States – federal, state, and local – each use taxes to pay for public programs.

Federal taxes

The federal government uses tax dollars to pay for things like national defense, education, health care for the poor, unemployment compensation, benefits such as food stamps and housing subsidies, medical research, transportation, natural resource protection and management, pensions for retired military personnel and government workers, and many other important national expenses.

Federal payroll taxes: Social Security and Medicare are among the largest programs that the federal government supports. Funds for these programs come mainly from payroll taxes.

- Social Security provides benefits for retired workers, people with disabilities, and the dependents of both.
- Medicare provides medical benefits for people who are 65 or older, certain younger people with disabilities, and people with permanent kidney failure requiring dialysis or a transplant.

Other federal taxes: Income taxes and tariffs are two other types of federal taxes.

State taxes	Local taxes
<p>States use taxes to provide services such as police, road and bridge construction and maintenance, social programs for the poor and elderly, and support for local public-school districts.</p> <p>Taxes vary depending on the state. Most states have an income tax. Some states do not. Many states have sales taxes, and some have property taxes. State property taxes are collected on items such as cars and boats. Some states don't require certain individuals to pay income taxes or sales taxes.</p>	<p>Local governments (such as counties, cities, and towns) use taxes to provide services such as police and fire protection, road and bridge construction and maintenance, and social programs for the poor and elderly. Local taxes also are the primary source of funds for public schools.</p> <p>Taxes vary depending on the local government. A few local governments have an income tax. Many use sales taxes, and some use property taxes. Local property taxes are collected on items such as houses and condominiums.</p>

What are some helpful things to know about filing income taxes?

People who work for an employer or work for themselves likely have to file a tax return. Employers report the taxes they withhold (income, Social Security, and Medicare taxes) on Form W-2. Employees use the information on Form W-2 to complete their individual income tax returns. All wages, salaries, bonuses, commissions, and tips are taxable, even if they are not reported on Form W-2.

Self-employed workers don't receive a W-2. Some self-employed people complete work for a company or individual and are considered contractors, not employees of that company or individual. These self-employed people receive Form 1099-NEC and use the income information on that form to complete their tax returns.

Sometimes, young people may think they shouldn't file a tax return because they didn't earn enough money or because they're still supported by their parents or guardians. But many people may lose out on their tax refund simply because they didn't file a federal income tax return. A tax refund is money owed to taxpayers when their total tax payments are greater than the total tax.



You can file your federal income tax return for free. Visit <https://www.irs.gov/filing/free-file-do-your-federal-taxes-for-free> for more information.

Understanding taxes and your paycheck

Students analyze statements about taxes to better understand how taxes affect people's paychecks.

Learning goals

Big idea

Understanding why and how taxes and other items are deducted from a worker's paycheck is an important step toward gaining financial knowledge.

Essential questions

- What are taxes and why do we pay them?
- How do taxes affect the money a person receives in their paycheck?

Objectives

- Understand what taxes are deducted from our paychecks
- Understand how these deductions affect our paychecks

What students will do


- Determine which statements about taxes are true or false.
- Participate in a class discussion about taxes and paychecks.

NOTE

Please remember to consider your students' accommodations and special needs to ensure that all students are able to participate in a meaningful way.

KEY INFORMATION

Building block:

 Financial knowledge and decision-making skills

Grade level: High school (9-12)

Age range: 13-19

Topic: Earn (Getting paid, Making money, Paying taxes)

School subject: CTE (Career and technical education), English or language arts, Social studies or history

Teaching strategy: Direct instruction, Gamification

Bloom's Taxonomy level: Understand, Apply

Activity duration: 45-60 minutes

National Standards for Personal Financial Education, 2021

Earning income: 8-5, 8-6, 8-7, 8-8, 8-9, 12-6, 12-7, 12-10, 12-11

These standards are cumulative, and topics are not repeated in each grade level. This activity may include information students need to understand before exploring this topic in more detail.

Preparing for this activity

- ☐ While it's not necessary, completing the "[Becoming familiar with taxes](#)" activity first may make this one more meaningful.
- ☐ Print copies of all student materials for each student, or prepare for students to access them electronically.
- ☐ Become familiar with the Federal Trade Commission resource on paychecks at <https://consumer.gov/managing-your-money/your-paycheck#what-it-is>.
- ☐ Become familiar with the "[Taxes: Understanding the basics](#)" handout.
- ☐ Print a copy of the answer guide (in this guide) so you can read the statements about taxes to the class and share answers.
- ☐ Consider displaying the "How to read a pay stub" poster before doing this activity.
 - You can order the poster for free here: <https://pueblo.gpo.gov/CFPBPubs/CFPBPubs.php?PubID=13465>.
- ☐ Obtain a computer or tablet with Internet access for each team of students.
- ☐ Obtain a computer and a projector or a smartboard so you can review the web resource with students.

What you'll need

THIS TEACHER GUIDE

- Understanding taxes and your paycheck (guide)
[cfpb_building_block_activities_understanding-taxes-paycheck_guide.pdf](#)
- A copy of the answer guide (in this guide)
- The Federal Trade Commission resource on paychecks at
<https://consumer.gov/managing-your-money/your-paycheck#what-it-is>
- Computer and a projector or smartboard

STUDENT MATERIALS

- Understanding taxes and your paycheck (worksheet)
[cfpb_building_block_activities_understanding-taxes-paycheck_worksheet.pdf](#)
- Computers or tablets with Internet access
- Taxes: Understanding the basics (handout)
[cfpb_building_block_activities_taxes-understanding-basics_handout.pdf](#)

Exploring key financial concepts

When you get your first paycheck, the terms and amounts on the pay stub may not always be easy to understand. You may wonder why your take-home pay is different from what you expected, based on what you earned. In fact, after getting your first paycheck, it's not uncommon to ask, "Where did all my money go?" This may be your first direct experience with paying payroll and income taxes. Understanding why and how taxes and other items are deducted from a worker's paycheck is an important step toward gaining financial knowledge.

TIP

Because terms and laws related to taxes change, students should be encouraged to always look for the most up-to-date information.

Teaching this activity

Whole-class introduction

- Ask students to share what they know about taxes.
 - If needed, explain that governments collect different taxes, including personal income tax, sales tax, and property tax. The money collected from taxes is used for public services that benefit society as a whole, such as public schools, police protection, public libraries, community centers, and parks.
- Read the "Exploring key financial concepts" section to students.
- Be sure to explain to students that people who are self-employed, such as entrepreneurs or ride-share drivers, also have to pay taxes, but those taxes aren't withheld from their earnings. They have to pay taxes on their own.
- Give students the "Taxes: Understanding the basics" handout and give them a few minutes to read it.
- Tell students they'll divide into teams and play a game where they'll decide whether statements about paychecks and taxes are true or false.
- Let students know that if they're unsure whether a statement is true or false, they can use a government webpage and the handout to help them confirm the correct answer.
- Using a projector or a smartboard, review the Federal Trade Commission resource on paychecks at <https://consumer.gov/managing-your-money/your-paycheck#what-it-is> with students.
 - Note: If you don't have technology available to show the webpage, you can print and copy the information for students.

- Be sure students understand key vocabulary:
 - **Federal Insurance Contributions Act (FICA):** A law that requires taxes to be deducted from your pay to contribute to Social Security and Medicare; your employer contributes the same amount on your behalf.
 - **Medicare:** A health insurance program for people who are 65 or older, certain younger people with disabilities, and people with permanent kidney failure requiring dialysis or a transplant; financed by deductions from wages and managed by the federal Social Security Administration.
 - **Payroll tax:** Taxes taken from your paycheck, including Social Security and Medicare taxes.
 - **Social Security:** Provides benefits for retired workers and people with disabilities, as well as the unmarried children, surviving spouses, or former spouses (in certain cases) of both.
 - **Tax credit:** A dollar-for-dollar reduction in a tax. It can be deducted directly from taxes owed. Tax credits can reduce the amount of tax you owe or increase your tax refund, and some credits may result in a refund even if you don't owe any tax.
 - **Tax deduction:** An amount (often a personal or business expense) that reduces income subject to tax.
 - **Taxes:** Required payments of money to governments, which use the funds to provide public goods and services for the benefit of the community as a whole.

TIP

Visit CFPB's financial education glossary at consumerfinance.gov/financial-education-glossary/.

Group work

- Divide students into teams.
- Distribute the "Understanding taxes and your paycheck" worksheet to each student.
- Give a computer or tablet with Internet access to each team.
- Tell students they'll only have 15–20 minutes to complete their worksheets.
- Suggest that one student on each team read each statement aloud and that the team then work together to determine whether the statement is true or false.
- Invite students to share their thoughts and opinions openly with teammates.

- Remind teams that they can review <https://consumer.gov/managing-your-money/your-paycheck#what-it-is> and the “Taxes: Understanding the basics” handout if they’re stuck.
 - However, they’ll only have 15-20 minutes to respond to the statements so time is very limited. They’ll need to think of creative ways to confirm their responses.
- Once the teams have finished, read each statement on the answer guide one at a time and ask each team to indicate whether they believe the statement is true or false.
 - If they think it’s true, they’ll give a thumb’s up sign.
 - If they think it’s false, they’ll give a thumb’s down sign.
- After the voting for each statement, invite students to discuss the reasons for their responses.
 - Be sure each group contributes to the discussion.
- Share the correct answer with students and use the answer guide to help extend the discussions related to the questions.

Wrap-up

If there’s time, have students answer the reflection question on their own and share their responses.

Suggested next steps

Consider searching for other [CFPB activities](#) that address the topic of earning, including getting paid, making money, or paying taxes. Suggested activities include [“Calculating the numbers in your paycheck”](#) and [“Investigating taxes in your life”](#).

Measuring student learning

Students’ answers on their worksheets and during discussion can give you a sense of their understanding.

The answer guide on the next page provides possible answers for the “Understanding taxes and your paycheck” worksheet. **Keep in mind that students’ answers may vary.** The important thing is for students to have reasonable justification for their answers.

Answer guide

1. People often confuse a paycheck and a pay stub. A pay stub is what you use to get your money.

FALSE: A pay stub comes with your paycheck and tells you how much money you earned, the pay period you're getting paid for, and what taxes and other money have been deducted from your pay. A paycheck is the money you receive for doing your job after deductions. You can get the money from your bank or credit union account if your employer directly deposits it there. You can also receive your paycheck on a payroll card. In some cases, people receive a paper paycheck that they deposit in their account or give to a bank, credit union, or other business to get cash.

2. People often confuse gross income and net income. Net income is what you actually receive after deductions.

TRUE: Gross income is all the money you earned at your job. But you don't get to keep all of your gross income because your employer takes money out to pay for taxes and benefits. Net income, which is also called take-home pay, is the money you get in your paycheck after the deductions.

3. FICA is another name for Federal Income Tax.

FALSE: FICA stands for the Federal Insurance Contributions Act, the law authorizing the federal government to collect payroll taxes. The federal government uses FICA taxes from your paycheck to support Social Security and Medicare programs.

4. Federal law requires employers to deduct money for federal income taxes and payroll (FICA) taxes (Social Security and Medicare taxes).

TRUE: Federal law requires employers to deduct money for federal income taxes and payroll (FICA) taxes (Social Security and Medicare taxes).

5. Your withholdings selections allow you to choose how much money your employer takes out of your paycheck for income taxes.

TRUE: By selecting your withholdings on your W-4 form, you can choose how much money your employer takes out of your paycheck for income taxes. When you have a big change in your life (such as getting married, having a baby, or changing your job), the amount of income taxes you owe may increase or decrease. To have the right amount of money deducted for income taxes, you change your withholdings.

6. Sales taxes are deducted from your paycheck.

FALSE: You pay sales taxes when you buy goods and services, including things like cars, clothes, and movie tickets.

Reflection question

Answers will vary and may include deductions for insurance and retirement.