

Introduction to Income Taxation

Introduction to Income Taxation – Study Notes

1. What Is Income Tax?

Aspect	Description
Definition	A levy imposed by governments on the net earnings of individuals, businesses, and other entities.
Purpose	- Fund public services (education, health, infrastructure). - Redistribute wealth. - Influence economic behavior (e.g., incentives, disincentives).
Jurisdiction	Usually administered at the national/federal level; many countries also have state, provincial, or local income taxes.

2. Core Concepts & Terminology

Term	Meaning
Gross Income	Total income before any deductions (e.g., wages, interest, dividends, rent).
Adjusted Gross Income (AGI)	Gross income minus specific “above-the-line” adjustments (e.g., contributions to retirement accounts, student loan interest).
Taxable Income	AGI minus standard deduction or itemized deductions and personal exemptions.
Tax Bracket	Range of taxable income taxed at a specific marginal rate. Most systems are progressive (higher rates for higher incomes).
Marginal Tax Rate	The rate applied to the next dollar of taxable income.
Effective Tax Rate	Total tax paid ÷ total income; reflects the average rate across all brackets.
Tax Credit	Dollar-for-dollar reduction of tax liability (e.g., child tax credit).
Tax Deduction	Reduces taxable income (e.g., mortgage interest, charitable contributions).
Withholding	Pre-payment of tax from wages or other income, remitted to the tax authority by the payer.

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Term	Meaning
Self-Assessment	Taxpayers calculate and report their own tax liability (common in many jurisdictions).

3. Types of Income Subject to Tax

Category	Examples
Earned Income	Salaries, wages, bonuses, commissions, tips.
Investment Income	Interest, dividends, capital gains, rental income, royalties.
Passive Income	Income from limited partnerships, trusts, or other activities where the taxpayer is not actively involved.
Other Income	Alimony (in some jurisdictions), unemployment benefits, gambling winnings, certain fringe benefits.

Note: Some items may be **exempt** or **partially exempt** (e.g., certain social security benefits, municipal bond interest).

4. The Tax Calculation Process

1. **Determine Gross Income** – Add all sources of income for the tax year.
 2. **Apply Adjustments** – Subtract allowable “above-the-line” deductions ? **Adjusted Gross Income (AGI)**.
 3. **Subtract Deductions** – Choose **standard deduction** or **itemized deductions** (whichever is larger).
 4. **Apply Personal Exemptions** (if permitted).
 5. **Result = Taxable Income.**
 6. **Apply Tax Rates** – Use the progressive tax-rate schedule to compute tax liability.
 7. **Subtract Tax Credits** – Directly reduce the liability.
 8. **Account for Pre-payments** – Withholding, estimated tax payments, and refundable credits.
 9. **Final Outcome** – **Tax due** (pay additional) or **refund** (receive excess).
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5. Progressive Taxation – How Brackets Work (Illustrative Example)

Taxable Income Marginal Rate

\$0 – \$10,