

# THE BASIC FORMULA FOR FEDERAL INCOME TAX



**INCOME**

- EXCLUSIONS

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**= ADJUSTED GROSS INCOME (AGI)**

**AGI**

- EXEMPTIONS  
- DEDUCTIONS

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**= TAXABLE INCOME**

**TAXABLE INCOME  
X TAX RATES**

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**= TAX LIABILITY**

**TAX LIABILITY**

- CREDITS

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**= TAXES PAID**

THE FEDERAL GOVERNMENT TAXES SALARIES, WAGES, INVESTMENTS, AND OTHER TYPES OF INCOME.

EXCLUSIONS ARE TYPES OF INCOME THAT ARE NOT TAXED, SUCH AS MUNICIPAL BOND INTEREST.

PERSONAL EXEMPTIONS ARE INDIVIDUAL TAX BENEFITS FOR EACH TAXPAYER AND DEPENDENT.

DEDUCTIONS CAN BE STANDARD OR ITEMIZED TO ENCOURAGE BEHAVIOR SUCH AS CHARITABLE CONTRIBUTIONS.

THERE IS NO SINGLE "TAX RATE". THE US UTILIZES A PROGRESSIVE TAX RATE SYSTEM MEANING THAT TAXABLE INCOME IS DIVIDED INTO SEGMENTS AND EACH SEGMENT IS TAXED AT A DIFFERENT RATE. THE RATE INCREASES FOR EACH INCOME SEGMENT.

CREDITS DIRECTLY REDUCE TAX LIABILITY (TAXES OWED) AND ARE RELATED TO A SPECIFIC TAXPAYER CIRCUMSTANCE, EXPENDITURE, OR INCOME LEVEL.

ONE EXAMPLE IS THE CHILD TAX CREDIT.

