Key Terms

Pre-tax income. The term "pre-tax" is used to describe compensation that an employee receives from an employer that is not subject to income tax or FICA payroll taxes. Normally, if an employee earns a dollar in wages, the employee must pay federal and state taxes on that dollar. Federal law provides that certain types of compensation received by an employee, including employer contributions to health insurance, are not subject to federal income tax or FICA taxes. Federal law also permits employers to establish arrangements that permit employees to pay their share of health insurance premiums with income that is not subject to income or payroll taxes.

Adjusted gross income (AGI). AGI is defined as: "taxable income from all sources . . . minus specific deductions such as education expenses, the IRA deduction, student loan interest deduction, tuition and fees deduction, Archer MSA deduction, moving expenses, one-half of self-employment tax, self-employed health insurance deduction, self-employed SEP, SIMPLE, and qualified plans, penalty on early withdrawal of savings, and alimony paid by [the tax payer]." (Available online at: http://www.irs.gov/app/freeFile/html/moreInfo/more_info_agi.html.)

Deduction. A deduction is an amount that a person can subtract from their adjusted gross income when calculating the amount of tax that they owe.

Standard deduction. The basic standard deduction is a specified dollar amount that taxpayers can deduct from their income in determining their taxes. (See Table 7, available online at http://www.irs.gov/publications/p501/ar02.html.) The amount varies with the filing status (e.g., single, married filing jointly, etc.) of the taxpayer. A taxpayer can take the standard deduction or can take deductions related to specified expenses (referred to as itemized deductions).

Credit. A tax credit is an amount that a person can subtract from the amount of income tax that they owe. If a tax credit is refundable, the taxpayer can receive a payment from the government to the extent that the amount of the credit is greater than the amount of tax that the individual would otherwise owe.

Personal exemption. A personal exemption is an amount that a taxpayer can deduct for themselves and their dependents when calculating taxable income.

FICA. The Federal Insurance Contributions Act requires individuals and employers to pay a tax on compensation to fund Social Security and Part A of Medicare. Both the employer and the employee pay 6.2% (12.4% combined) on earnings up to the Social Security wage base ($102,000 in 2008) for the Social Security Program. Both the employer and the employee pay 1.45% (2.9% combined) of all wages for Part A of Medicare. The total combined FICA contribution on a dollar of earnings (for 2008) is 15.3% for wages up to $102,000 and 2.9% for wages above $102,000.

Medical expense deduction. Federal law permits taxpayers to deduct the portion of medical expenses, including premiums for health insurance, that exceeds 7.5% of adjusted gross income as an itemized deduction. (See IRS Publication 502 for more information, available online at: http://www.irs.gov/publications/p502/ar02.html.)

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