Name: _____ Date: _____

How the Federal Tax System Is Built

Reading level 13 · 1527 words

Ines Park is made up, but the list of numbers that decides her tax is real. She earns $70,000 in wages in 2026 and will file in 2027. On October 9, 2025, the Internal Revenue Service published that list in Revenue Procedure 2025-32, the yearly update to the tax tables that the tax code requires. For tax year 2026, a single filer may subtract $16,100 from income before any tax is figured, and the first $12,400 of what remains is taxed at 10 percent. This book follows Ines through the machinery that turns pay into a tax and a tax into a budget. The rules are real, and the arithmetic in her case is ours.

The Constitution gives Congress the power "to lay and collect Taxes," but it also sets a limit. Article I, section 9 says that no "direct" tax may be laid unless it is in proportion to the census. The Civil War produced the first American income tax, in 1861, and Congress repealed it in 1872. In 1894 Congress tried again, with a 2 percent tax on income over $4,000. In 1895 the Supreme Court struck it down in Pollock v. Farmers' Loan and Trust Company. The Court held that a tax on income from property was a direct tax, so it had to be apportioned, or divided, among the states by population. Congress passed the 16th Amendment in 1909, and since its ratification on February 3, 1913, it has allowed taxes on incomes "from whatever source derived, without apportionment among the several States."

The tax that followed was small. The Income Tax Act of 1913 set a normal tax of 1 percent on income above $3,000 for a single person or $4,000 for a married couple, and larger incomes also paid a surtax of 1 to 6 percent. Fewer than 400,000 returns met the filing threshold for 1913, and the IRS counts about $28 million in tax. The Treasury unveiled Form 1040 on January 5, 1914. It ran four pages, instructions included. By our arithmetic, the $2.846 trillion that individual income taxes brought in during fiscal year 2026 is about 100,000 times that $28 million. Dollars from 1913 and 2026 are not directly comparable, so treat the ratio as a scale only. By our arithmetic, Ines's $70,000 is more than twenty times the $3,000 line that decided who filed in 1913.

Collecting tax from each paycheck was not part of the early system. Collection at the source, which the 1913 law had included, was dropped for 1916. For about thirty years, the income tax reached only high-income households. World War II changed that, and the Current Tax Payment Act, signed on June 9, 1943, required employers to withhold income tax from wages, at 20 percent of the pay above a small exemption, beginning July 1, 1943. The change had a catch, because workers still owed the previous year's tax while paying the current year's as they earned. So Congress cancelled 75 percent of one year's bill for most taxpayers, the lower of 1942 or 1943. The IRS still calls the federal income tax a "pay-as-you-go tax."

A second system runs beside the income tax. The Social Security Act, signed on August 14, 1935, set up a payroll tax that began in 1937: employees paid 1 percent of the first $3,000 of pay. That is a maximum of $30 a year, by our arithmetic. In 2026 the Social Security tax is 6.2 percent for the employee and 6.2 percent for the employer. It applies to wages up to $184,500, a limit that the Social Security Administration sets each year. The Medicare tax is 1.45 percent each and has no limit, and the law adds 0.9 percent, paid only by the worker, on wages above $200,000. The Treasury says these taxes fund only Social Security and Medicare. For Ines, the two taxes come to $4,340 and $1,015, by our arithmetic.

Back to the income tax. A law signed in July 2025 made the seven rates permanent: 10, 12, 22, 24, 32, 35 and 37 percent. What changes each year is where the layers begin and end. Section 1(f) of the tax code tells the Treasury to publish new tables by December 15 for the next year, and its heading states the purpose: adjustments "so that inflation will not result in tax increases." Each dollar edge rises with the Chained Consumer Price Index, averaged over the 12 months that end on August 31, and increases are rounded down to a multiple of $50. The adjustment does not change the rates. Congress can still rewrite the tables, so every figure here carries its year.

Now Ines's return, using the 2026 numbers for a single filer. Wages of $70,000 minus the $16,100 standard deduction leave $53,900 of taxable income. The first $12,400 is taxed at 10 percent, which is $1,240. The next $38,000, up to $50,400, is taxed at 12 percent, which is $4,560. The last $3,500 is taxed at 22 percent, which is $770. The total is $6,570. The table in Rev. Proc. 2025-32, labeled Table 3 for unmarried individuals, saves the adding by printing the lower layers as one amount, $5,800, plus 22 percent of the excess over $50,400. Ines's marginal rate is 22 percent, which is the rate on her next dollar, while her average rate, the total tax divided by her wages, is 9.4 percent.

The two rates explain a common error. Some people think a raise can push a worker into a higher bracket and shrink the pay. But a bracket is a layer, and only the dollars above its line are taxed at its rate. Each dollar of a raise is taxed at the rate of the layer where it lands, and with a top rate of 37 percent the brackets alone always leave most of a raise in the worker's hands. The tax code does have credits that shrink as income rises. The Revenue Procedure's table for the Earned Income Tax Credit lists "phase-outs." That is a separate rule from the brackets, with its own arithmetic.

People also mix up deductions and credits, because both lower a tax bill. The IRS says a deduction is an amount you subtract from your income. A credit is an amount you subtract from the tax you owe. A deduction is worth its size times the rate on the layer it comes out of. Suppose Ines has a $1,000 deduction on top of the standard one. It lowers her taxable income to $52,900 and her tax to $6,350, which saves $220, because those dollars sat in the 22 percent layer. A $1,000 credit lowers her tax from $6,570 to $5,570. The IRS adds that some credits are refundable, which means they can pay out even when no tax is owed. For

2026 the top Earned Income Tax Credit is $8,231, for a family with three or more qualifying children.

The Treasury closes each fiscal year on September 30. Fiscal year 2026 began on October 1, 2025, and its final Monthly Treasury Statement is now out. Receipts were $5.403 trillion. Individual income taxes supplied $2.846 trillion, or 53 percent. Employment taxes, mostly Social Security and Medicare, supplied $1.754 trillion, or 32 percent. Corporation income taxes supplied $381 billion, about 7 percent, and customs duties and excise taxes supplied another $173 billion and $106 billion. Outlays were $7.396 trillion. The difference, $1.992 trillion, is a deficit, which the Treasury defines as spending more than the government collects. The Treasury says that federal spending is paid for primarily by tax collection and borrowing. The percentages are our arithmetic, and the Treasury can revise these totals in later reports. Ines's $6,570 will be one small piece of the individual income tax line.

The Treasury sorts spending into about twenty budget functions. For fiscal year 2026, Social Security was $1,667 billion, Medicare was $1,073 billion, net interest $1,052 billion, health programs apart from Medicare $1,026 billion, national defense $965 billion and income security $694 billion. All other functions made up $919 billion. A second sorting is by how Congress provides the money. The Treasury says discretionary spending is approved by Congress and the President each year, in the appropriations process. Mandatory spending is mandated by existing laws, and its guide gives Social Security as an example. GAO's budget glossary puts it in budget terms: discretionary spending is outlays controlled by yearly appropriation acts, and mandatory spending is outlays that result from other laws.

Ines will file in 2027, probably with a few lines of arithmetic: $70,000, less $16,100, then a row in a table. Behind each line stands a layer of history: a clause of the Constitution, an amendment ratified in 1913, a wartime law from 1943, a Social Security Act from 1935 that has been rewritten since, and a Revenue Procedure published on October 9, 2025. Her return will join the roughly 145 million that had reached the IRS by May 8, 2026, a count of returns and not of people, since one return can cover a household. All of them rest on the same few numbers, and those numbers will be replaced when the next ones are announced.

Questions

1. Why did the Supreme Court strike down the 1894 income tax in 1895?

A. It held that a tax on income from property was a direct tax that had to be apportioned
B. It held that Congress may never tax anyone's income in any way at all
C. It held that only the states may collect any taxes on income or on pay

2. In this book, what does it mean that a tax is withheld?

A. The government decides in advance not to collect the tax at all
B. An employer holds it back from wages and sends it to the government

C. A worker pays it a full year late, after filing the yearly return

3. Why does the 1943 law's cancellation of 75 percent of one year's tax matter to the story?

A. It made the income tax illegal for nearly every worker for good

B. It ended the 16th Amendment and sent the tax power back to the states

C. Workers would otherwise have paid two years of tax at once

4. For Ines in 2026, why does a $1,000 deduction save $220 while a $1,000 credit saves $1,000?

A. Credits only apply to people who earn less than $12,400 a year

B. A deduction lowers income, so it saves its size times the layer's rate; a credit lowers the tax itself

C. Deductions are always larger than credits, whoever claims them

5. What is the Social Security wage base for 2026?

A. $184,500

B. $16,100

C. $200,000

6. According to the book, how does mandatory spending differ from discretionary spending?

A. Mandatory spending is always larger than every discretionary program

B. Discretionary spending is the money used to pay interest on the debt

C. Mandatory spending comes from existing laws, and discretionary spending is approved in yearly appropriation acts

Words to know

apportioned: divided by population
withhold: hold back
marginal: per extra dollar
refundable: can pay out
discretionary: voted each year

Answer key: How the Federal Tax System Is Built

1. A. It held that a tax on income from property was a direct tax that had to be apportioned
2. B. An employer holds it back from wages and sends it to the government
3. C. Workers would otherwise have paid two years of tax at once
4. B. A deduction lowers income, so it saves its size times the layer's rate; a credit lowers the tax itself
5. A. $184,500
6. C. Mandatory spending comes from existing laws, and discretionary spending is approved in yearly appropriation acts