Crossing Hidden Thresholds May Drastically Bump Up Your Bill

Tax Rates: the Rest of the Story

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We used to enjoy listening to radio broadcasts by the late Paul Harvey. He would go into wonderful detail about an amazing accomplishment someone had achieved, in closing mention how the cards were even more stacked against that person yet the protagonist still prevailed…then he would end with his catchphrase, "And now you know the rest of the story."

In our last article, we answered the question, "What is your tax rate, and why does that matter?" We explained the difference between your marginal tax rate and your effective tax rate. This article will explore the hidden factors that raise taxes such as crossing the thresholds where Social Security taxes increase, the alternative minimum tax, high-income Medicare taxes on both earned and investment income, and phaseouts of both personal exemptions and itemized deductions. These issues only make predicting income taxes even more confusing.

The last article showed how knowing your marginal tax rate was important, but we only covered normal income tax brackets. There are several other factors that can change your marginal tax rate.

Social Security: Small Changes in Income Can Have a Big Impact on Tax Rates

The first component to skew income tax is Social Security. The reason for this is that Social Security retirement income isn't all taxable and has three brackets of its own: namely, 0 percent, 50 percent and 85 percent. Unlike the "normal" tax brackets, these trigger taxes at their rates on the entire amount of Social Security income.

Single Taxpayers Receiving Social Security

If you're single and receive $20,000 in Social Security benefits:

- **None of your benefits** is taxable if your other income is less than $15,000.
- **For every dollar** between $15,000 and $24,000, an additional 50 cents becomes taxable.
- **For every dollar** over $24,000, an additional 85 cents becomes taxable up to a total other income of $38,706, which makes the maximum $17,000 taxable.

Remembering that the marginal tax rate is the tax on the next dollar of income, a single filer in the 15 percent and 25 percent tax brackets with Social Security and other income can end up paying a much higher marginal rate — up to 46 percent in the 25 percent bracket! The table at the top of the next page assumes that you have no dependents, the 2016 exemption of $4,050 and the 2016 standard deduction of $7,850 for a single taxpayer over age 65, so your first $11,900 of income isn't taxable.

Married taxpayers Receiving Social Security.

If you're a married couple and receive $40,000 in Social Security benefits:

- **None of your benefits** is taxable if your other income is less than $12,000.
- **For every dollar** between $12,000 and $24,000, an additional 50 cents becomes taxable.
- **For every dollar** over $24,000, an additional 85 cents becomes taxable up to a total other income of $56,941, which makes the maximum $34,000 taxable. For married taxpayers, the effect isn't quite as pronounced:

So for incomes in these ranges, the level of tax on Social Security can skew different marginal rates, particularly for single filers. There are also several rules that have the effect of raising a taxpayer's marginal rate, particularly for higher-income filers. First we address the taxes on investments such as dividend and capital gains.

Other Traps: For Those With Higher Incomes, the Following May Apply

Medicare Net Investment Income Tax (NIIT) can add 3.8 percent tax to investment income.

An additional 3.8 percent federal Medicare tax applies to individuals on the lesser of net investment income or modified adjusted gross income in excess of $200,000 (single) or $250,000 (married filing jointly).

Note that if you have a gain on your home beyond the $250,000 single or $500,000 married home-gain exclusion, this tax will affect you even if your earned income level is smaller.

The alternative minimum tax can limit itemized deductions or increase capital gains tax.

If you follow Form 6251, you can see how complex AMT is and the specifics for your situation. Rather than explore this in detail, we feel it's important for you to know that it can raise the rate on long-term capital gains and all your income if you have a lot of itemized deductions or personal exemptions.

Look at Line 45 on your 2015 Form 1040 to see whether you pay AMT.

The Medicare surtax can add 0.9 percent to the existing 1.45 percent marginal rate for a total of 2.35 percent.

The thresholds for this tax on wages and on self-employed income are $250,000 of Medicare wages for married couples filing jointly and $200,000 of Medicare

Calculating Joe's Real Marginal Tax Rate

Base marginal rate	33.00 percent
Medicare tax plus surtax	add 2.35 percent
Medicare NIIT	add 3.80 percent
Pease	add 1.00 percent
PEP	add 1.00 percent
Subtotal	41.15 percent

Marginal Tax Rates for Single Filer

Non-SS income in $	Taxable Social Security in $	Adjusted gross income in $	Taxable income in $	Tax bracket	Additional SS taxed for each $1 in income	Marginal tax rate
11,900	0	11,900	0	10%	0.00	10.00%
15,000	0	15,000	3,100	10	0.50	15.00
19,117	2,058	21,175	9,275	15	0.50	22.50
24,000	4,500	28,500	16,600	15	0.85	27.75
35,379	14,171	49,550	37,650	25	0.85	46.25
38,706	17,000	55,706	43,806	25	0.00	25.00

Marginal Tax Rates for Married Filers

Non-SS income in $	Taxable Social Security in $	Adjusted gross income in $	Taxable income in $	Tax bracket	Additional SS taxed for each $1 in income	Marginal tax rate
12,000	0	12,000	0	0%	0.50	0.00%
19,467	3,733	23,200	0	10	0.50	15.00
24,000	6,000	30,000	6,800	10	0.85	18.50
30,351	11,398	41,750	18,550	15	0.85	27.75
35,379	34,000	90,941	67,741	15	0.00	15.00
38,706	34,000	98,500	75,300	25	0.00	25.00

wages for single filers. Below this level the Medicare tax is 1.45 percent. The tax is an additional 0.9 percent of wages earned above that amount.

Limits on itemized deductions (Pease) can add 1.0 percent to marginal rate.

The Pease rule limits itemized deductions. Although this is referred to as a limitation on itemized deductions, it's actually calculated based on income over a certain threshold. As a result, the Pease limitation is essentially a roughly 1.0 percent surtax on income once a married couple's 2016 adjusted gross income is above $311,300 or a single filer's adjusted gross income is above $259,400.

The Pease limitation triggers an itemized deduction limitation that's the lesser of 3 percent of AGI or 80 percent of the allowed itemized deductions.

The personal exemption phaseout, or PEP, can add 1.0 percent to marginal rate.

The personal exemption phaseout uses the same thresholds as the Pease limitation but reduces the allowed personal exemptions, each worth $4,050 in 2016. Unlike the Pease rule, the effect of personal exemptions can be completely eliminated. If a married couple's adjusted gross income reaches $433,800 or a single filer's AGI is $381,900, those taxpayers will lose all their personal exemptions.

Why Does This Matter?

Just as in last month's article, this may be the only way to estimate your real marginal rate to make financial decisions. But all the components have to be evaluated. First calculate your marginal rate from your federal income tax bracket, then add for each that may affect you as follows:

Let's say Joe is single, earns $260,000 a year and has few deductions. So, Joe's marginal tax rate from his tax bracket is 33 percent, but his real marginal rate is closer to 41 percent! *(See table at above left.)* Joe's marginal tax rate is 8 percentage points higher than his normal tax bracket. So Joe will save 41 percent by deferring more into his 401(k) if he can do so.

For those with more moderate income levels, the following example is critical. For an even more pronounced example, let's say Joe's friend Dan is single, age 68 and retired. Dan receives $20,000 a year from Social Security and currently distributes $17,000 a year from an independent retirement account even though he's not required to. Dan also has other money that isn't in a retirement account.

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as likely to move by a quarter as a $50 stock.

Yes, it does sound more exciting to own 1,000 shares of a low-priced stock rather than 100 shares of a typically priced stock. But the only thing that should matter to you is how much your investment goes up or down in dollars.

It's safest to assume penny stocks are low-priced for a reason. Either they don't have the financial strength to be listed on a traditional exchange or they've chosen to avoid the necessary costs and additional scrutiny from regulators.

Institutional investors usually shun penny stocks. If a company wants to attract institutional investors, which would presumably increase demand and hopefully the share price, it would rationally seek to list the shares on an exchange.

Companies that cannot or are choosing not to do so are putting a red flag up for individual investors. You should be very wary before investing in them.

Websites of Interest

U.S. Securities and Exchange Commission: Penny Stock Rules

www.sec.gov/answers/penny.htm

Sam Levine frequently writes for this magazine.

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Dan rationalizes that he has much more in his IRA than his regular individual portfolio and that he's done this for years without any significant tax issue.

Next year Dan wants to buy a new car. Dan is planning to distribute the $17,000 plus an additional $21,000 for a total of $35,000 from his IRA. Dan says to himself, "This has been fine in the past, what could go wrong?" Dan has unwittingly fallen into a trap that will increase his taxes substantially. Dan's federal income tax in 2015 would be about $600, whereas his 2016 income tax would be about $5,100. This is all because the $20,000 Dan gets from Social Security went from $1,000 being taxable to $13,850 being taxable.

This means Dan's 2016 real marginal tax rate is about 24.5 percent, even though he's in the 15 percent tax bracket. Dan is a bit unhappy — he really didn't see that coming!

Now let's assume Dan needs a bit more in 2016 than he thought he needed, so he takes an additional $4,000 from his IRA. Dan's taxes will go from about $5,090 to $6,830. Dan's taxes go up by $1,740 on an additional $4,000 of income because Dan is in the 43.5 percent real marginal tax rate. All this is because Dan's Social Security income went from $13,850 being taxed to $17,000 being taxed.

Dan is now digging a deeper hole even faster than before — what an unpleasant surprise! Dan's AGI is $200,000 less than Joe's, yet Dan is in a higher marginal tax rate.

As Paul Harvey would say, "Now you know the rest of the story!"

We recommend you compute and project what increasing your income will do to your taxes so that you'll know the effect of your decisions on taxes.

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Ms. Armstrong and Mr. Wright can't answer individual inquiries, but they welcome suggestions for future article topics.

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