Know How Marginal and Effective IRS Rates Impact Your Finances

Today's Choices Can Cut Your Taxes

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We find many clients have difficulty responding when asked, "What is your tax rate?" Discussions about taxes often are confusing because there are two different tax rates for the same taxpayer: your marginal rate and your effective rate. It's important to understand the difference to evaluate how changes in finances will affect your taxes. Knowing your marginal rate allows you to predict how changes in income and deductions will affect your taxes. Incorrectly using your effective rate will underestimate how changes in income and deductions will affect your income tax. Although every investor and taxpayer should know this information, few do.

Apart from there being two tax rates, all the hidden things that raise taxes such as alternative minimum tax, high-income Medicare taxes on both earned and investment income, and phaseouts of both personal exemptions and itemized deductions only serve to make this more confusing.

In this article, we seek to clarify the difference between marginal and effective tax rates and why applying the correct rate is important. We're ignoring state rates because of the many differences in state income tax.

Let's start by discussing our tax structure. Our federal income tax system is progressive, meaning the more you make, the higher percentage you pay. Each of these progressions is referred to as a bracket.

In reality it's better to view the different levels as buckets. Once the smaller bucket fills up (the lower brackets), the excess flows into a larger bucket (a higher rate bracket).

This is what causes the effective rate to be lower than the marginal rate. The marginal rate refers to what "bucket" the taxpayer is currently filling. Higher marginal tax rates correspond to higher levels of income. For example, the first "bucket" of any taxpayer's taxable income is taxed at a 10 percent rate, the next portion is taxed at a 15 percent rate and so on, up to a top marginal rate of 39.6 percent. The chart on page 13 shows how this works for 2015 taxes.

Your marginal tax bracket indicates how much your taxes increase or decrease with the next dollar of increased or decreased taxable income.

On the 2015 Form 1040, look at Line 43 on page 2. Barring the complexities of AMT, additional Medicare taxes on earned income, additional Medicare taxes on investment income, phaseouts of itemized deductions (Line 29, Schedule A) and phaseouts of personal exemptions (Line 42 on Form 1040), the number on Line 43 will help you determine your marginal tax bracket by using the table in this article. In our next article, we'll explore those complexities.

A Marginal Rate of 25 Percent

Think of each rate on the left-hand side as the name of the bucket. The capacity of the bucket is noted for each in terms of taxable income for the two most usual filing statuses. Once the bucket at the top of the chart is full, taxes go to the next bucket below. So once the ceiling for that bucket (bracket) is reached, the taxpayer graduates to the next level.

Let's say John is a single taxpayer with taxable income of $85,000 and is in the 25 percent bracket. He has gotten there by filling the 10 percent and 15 percent brackets. In fact, John will pay:

- **10 percent tax** on income to $9,225, which equals $922.50, plus
- **15 percent tax** on income more than $9,225, which equals $5,156.25, plus
- **25 percent tax** on income more than $37,450, which equals $11,887.50, for a total of
- **$17,966.25** in federal income tax

Note that not all the income was taxed at 25 percent; in fact $85,000 times 25 percent would be a higher $21,250 in tax. Even more important though, and the crux of the issue, the marginal rate is based on "taxable income" (Line 43 on your 2015 Form 1040), not adjusted gross income (AGI, Line 37 on your 2015 Form 1040).

Why Does This Matter?

Financial decisions are generally made based on the effect of changing income or deductions. Unless the change in income drives the taxpayer into a higher tax bracket, the change can be reasonably estimated by using the change times the marginal bracket. The marginal rate indicates the effect of a change in income.

In our example, let's look at John's income taxes for 2015. John has a 401(k) at work and understands that deferring pay into the 401(k) will lower his taxes. Remember, John is in the 25 percent bracket. If John had contributed $10,000 to his 401(k) in 2015, John's taxes would have been reduced by 25 percent of his 401(k) contribution or $2,500. In this manner, marginal tax brackets are helpful for showing the change in taxes but not what taxes actually will be. That is why marginal rates must be used to analyze changes.

What if I Go Into a Higher Bracket?

Suppose John gets a promotion and a large raise of

$19,750. John is now squarely in the 28 percent tax bracket with a taxable income of $104,750. He'll have filled the 25 percent bucket up to capacity at $90,750 and the overflow of $14,000 will be taxed at 28 percent. The increase in taxes will be 25 percent times the amount needed to complete the 25 percent bucket (which is $5,750), plus 28 percent times the amount in the 28 percent bucket of $14,000.

John's taxes will go up by

(0.25 x $5,750) + (0.28 x $14,000) = $5,357.50

Now John wants to know what effect putting the same $10,000 in the 401(k) will have. Since John is now in the 28 percent bracket and deferring $10,000 into the 401(k) will not put him back into the lower bracket, a $10,000 401(k) contribution saves him 28 percent, or $2,800 in taxes. Your marginal tax bracket indicates how much your taxes increase or decrease with the next dollar of increased or decreased taxable income.

What About My Effective Rate?

John's adjusted gross income for 2015 was $116,353. John is single with no dependents and can therefore claim himself as a personal exemption ($4,000). His itemized deductions totaled $27,353.

This included $14,000 in mortgage interest, $5,000 of real estate taxes, $7,353 of Maryland state income tax and $1,000 to charity.

This leaves John with taxable income of $85,000, which puts him in the 25 percent marginal tax bracket with a tax due of $17,044, as we illustrated above.

John's AGI is $116,353 on Line 37 of his 2015 Form 1040 and his total tax is $17,044 on Line 63 of his Form 1040. John's effective tax rate is $17,044/$116,353, or 14.6 percent. If we want to analyze what happens if John had contributed to his 401(k), we cannot use this 14.6 percent rate! Instead, we must use the 25 percent marginal rate.

What we're illustrating here is that your marginal rate is more important than your overall effective tax rate in making most financial decisions. The effective rate is good to know to see the percentage of your cash flow going to federal income tax, but the buckets, or brackets, are generally more helpful.

We recommend you compute your marginal and effective tax rates for your 2015 taxes. The marginal brackets usually change each year. Above is the table for 2016.

What will your marginal tax rate most likely be in 2016? Knowing this means you may be able to figure out how postponing income or accelerating deductions will lower your federal income taxes in 2016.

How Postponing Income or Increasing Deductions Will Lower Your Federal Income Tax Rate in 2015

Marginal Tax Rate	Single Filer's Taxable Income	Married Joint Filer's Taxable Income
10%	$ 0 - 9,225	$ 0 - 18,450
15	9,225 - 37,450	18,450 - 74,900
25	37,450 - 90,750	74,900 - 151,200
28	90,750 - 189,300	151,200 - 230,450
33	189,300 - 411,500	230,450 - 411,500
35	411,500 - 413,200	411,500 - 464,850
39.6	413,200 and more	464,850 and more

How Postponing Income or Increasing Deductions Will Lower Your Federal Income Tax Rate in 2016

Marginal Tax Rate	Single Filer's Taxable Income	Married Joint Filer's Taxable Income
10%	$ 0 - 9,275	$ 0 - 18,550
15	9,275 - 37,650	18,550 -75,300
25	37,650 - 91,150	75,300 - 151,900
28	91,150 - 190,150	151,900 - 231,450
33	190,150 - 413,350	231,450 - 413,350
35	413,350 - 415,050	413,350 - 466,950
39.6	415,050 and more	466,950 and more

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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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