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Tax Bracket and Income Tax Rates

A common misunderstanding about the income taxes you will owe is based on the difference between your "marginal tax rate" and your "effective tax rate."

And knowing the difference between the two can be very helpful in making good financial decisions. Let's look at both:

Marginal tax rate: Your marginal tax rate is the amount of tax you will pay on the NEXT taxable dollar you earn. It is simply the mathematical outcome of earning one more dollar on top of all the other taxable income you expect to have in a given year.

The answer to the tax bracket question is based on several concepts. First, what type of tax will you incur on that next dollar? If the money is coming from a tax-free municipal bond, then you likely won't pay ANY tax because, as the name suggests, it's "tax free." So maybe, no tax.

If the next dollar is coming from work or interest, then most likely it will be treated as "ordinary income" and it will be subject to the tax grid below. In this case, you will need to see where you fall on the grid. If you are single and expect to have an income of $52,000 for the year, then your NEXT dollar of taxable income would put you in the "$41,775 to $89,075" range and thus your MARGINAL tax on ORDINARY income would be 22%. Thus, your tax bracket would be 22%, meaning that that the next dollar you earn will be taxed at 22%.

Single Taxable Income Exceeding...	Married Filing Jointly	Ordinary Income	Capital Gains Tax Rate
$0	$0	10%	0%
$10,275	$20,550	12%	0%
$41,475	$83,350	12%	15%
$41,775	$83,550	22%	15%
$89,075	$178,150	24%	15%
$170,050	$340,100	32%	15%
$215,950	$431,900	35%	15%
$459,750	$517,200	35%	20%
$539,900	$647,850	37%	20%

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However, if the next dollar you earn is taxed like a capital gain (say, you sold some stock at a profit), then the marginal tax would be calculated based on the Capital Gains column.

In this case above, a single person incurring a capital gain, with income over $41,775, would be subject to a tax of 15%. Thus, the marginal rate would 15% rather than 22% if it were ordinary income.

If you understand this distinction, then you can see why it's important to know your marginal tax bracket. You need to know AHEAD OF TIME, what tax you will incur when making financial decisions like funding a Roth IRA vs a Traditional IRA or whether you should sell a stock in December or wait until the next tax year.

As important as knowing this information is, don't confuse it with the other important term, EFFECTIVE tax rate. The effective tax rate is simply a calculation of the total amount of tax you pay (ordinary income and capital gains) divided by the total income you receive. It's common for folks to mistakenly think that if they fall into a higher tax bracket that ALL of their income will be subject to the new higher rate. This is NOT the case. Recall that only the NEXT dollar you make is subject to the higher bracket.

For example, the same single person making $52,000 will find themselves in the 22% tax bracket as we identified earlier. So, the next dollar of ordinary income they earn will incur a 22% tax. However, the first $10,275 they earned incurred a 10% tax. And the next $31,500 ($41,775 - $10,275) incurred a 12% tax. It's only the amount ABOVE $41,775 that is taxed at 22%. Therefore, the total tax this person would pay is $7,057 (the portion taxed at 10% plus the portion taxed at 12% plus the excess taxed at 22%). If we divide $7,057/$52,000 we see that the EFFECTIVE tax rate of ALL money is roughly 13.6%.

Knowing the difference between marginal and effective tax rates and understanding the types of taxation you will incur is vital to efficient decision making. When in doubt, talk to a tax accountant or your financial adviser to understand your options.

Lehigh Valley Investment Group does not offer tax advice or services. Speak with a tax professional regarding your specific situation.

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