

Marginal Tax Brackets

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We have a graduated income tax system. The tax rates for 2001 start at 15% and go up to 39.1%. The key here is “graduated.” That means that you pay higher rates as your income goes up. For example, a married couple pays 15% on the first \$45,200 of taxable income. (Taxable income is calculated by taking your total gross income less either a standard deduction or itemized deductions, and less your exemptions.) Taxable income above \$45,200 and up to \$109,250 is taxed at 27.5%.

Suppose that you just completed your taxes and that your final taxable income came to \$45,201. That’s right, you are now in the 27.5% income tax bracket by \$1.00 and you can’t find any more deductions! The question is, “how much additional tax do you now owe as a result of being in a 27.5% bracket rather than a 15% tax bracket?”

I’m not asking you to get out your calculator here. Think about the concept. If you are thinking that the answer is to multiply your entire \$45,201 taxable income by 27.5%, you’re wrong. The correct answer is as follows: The first \$45,200 of income is still taxed at 15%. The one dollar in the higher tax bracket (from \$45,200 to \$45,201) is taxed at 27.5%. Therefore, you pay an extra 12.5 cents from your “higher tax bracket.”

One of the most misunderstood concepts about income taxes is what happens when a person goes into the next “tax bracket.” Many people believe that having enough income to be in the next tax bracket will cost you plenty in extra taxes. Your “marginal tax bracket” is the amount of tax you pay on the last or next dollar of income. Your marginal tax bracket is always higher than your “average tax bracket” which is your total taxes divided by your total income. This occurs because as you earn more dollars, the new dollars are taxed at higher rates than the existing dollars.

So the reality is that “going into a higher tax bracket” isn’t really a big deal after all. It is just the amount in the higher tax bracket that is subject to the higher rate. The lower amounts are still taxed at their respective rates.