

Effective tax rate vs. marginal tax rate

The recent release of Mitt and Ann Romney's 2010 federal income tax return provides an interesting lesson in the difference between one's marginal tax rate and the effective tax rate. Pundits have pointed out that the Romneys paid \$3 million in federal income tax on \$21.6 million in adjusted gross income, for an effective tax paid of only 13.9%. A closer analysis of their tax return, however, shows that in 2010 the Romneys were in the top marginal tax bracket of 35%, and in addition they paid an alternative minimum tax of \$232,989.

How to explain the discrepancy? In the Romneys' case, the primary reason is that more than half of their income is comprised of qualified dividends and long-term capital gains, which (until the end of 2012) are taxed at a top rate of 15%. But their other income, such as interest and business income from speaking fees, easily exceeded the \$373,650 required to put them in the top marginal bracket of 35%, even after subtracting adjustments to income, itemized deductions and personal exemptions.

Here's an example of the difference between effective tax rate and marginal tax rate. Suppose in 2012 Jim and Janie Doe have exactly \$100,000 in adjusted gross income. To keep things simple, none of it is qualified dividends or long-term capital gains. Mr. and Mrs. Doe also have exactly \$20,000 in itemized deductions and \$7,600 in personal exemptions (two exemptions, no dependents). Their taxable income, therefore, is \$72,400 (= \$100,000 minus \$20,000 minus \$7,600).

According to the 2012 federal income tax tables, because the Does' taxable income exceeds \$70,700, their marginal tax rate is 25%. That is, every dollar of taxable income over \$70,700 is taxed at 25%. According to the tax table, their tax bill is \$9,735 on the first \$70,700, plus \$425 (= 25% x \$1,700) on the excess over \$70,700, for a **total tax bill of \$10,160**. Thus, even though the Does are in the 25% marginal tax bracket, their effective tax rate on \$100,000 of adjusted gross income is only 10.2%.

Let's extend the example. Suppose instead Mr. and Mrs. Doe have \$200,000 in adjusted gross income and the same deductions and exemptions as before. Now their taxable income is \$172,400. This puts them in the 28% marginal tax bracket. The Does' total tax bill for 2012 is **\$36,051**, which makes their effective tax rate 18.0%, once again much lower than the marginal tax rate. On the second \$100,000 in income, with no change in deductions, Mr. and Mrs. Doe will pay an additional \$25,891 in taxes (= \$36,051 minus \$10,160).

This example illustrates how citing an effective tax rate can be misleading. In general, one's effective tax rate is always lower than one's marginal tax rate.

Please contact your Relationship Manager if you have any questions about the subject of this email, or feel free to contact CIM's Wealth Strategist, Art Dicker, at (518) 391-4280.

Circular 230 disclaimer: If any advice concerning one or more U.S. Federal tax issues is contained in this communication (including any attachments), such advice is not intended or written to be used, and cannot be used, for the purpose of avoiding penalties under the Internal Revenue Code or promoting, marketing or recommending to any party any transaction or matter addressed herein.