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Understanding Income Tax Calculations

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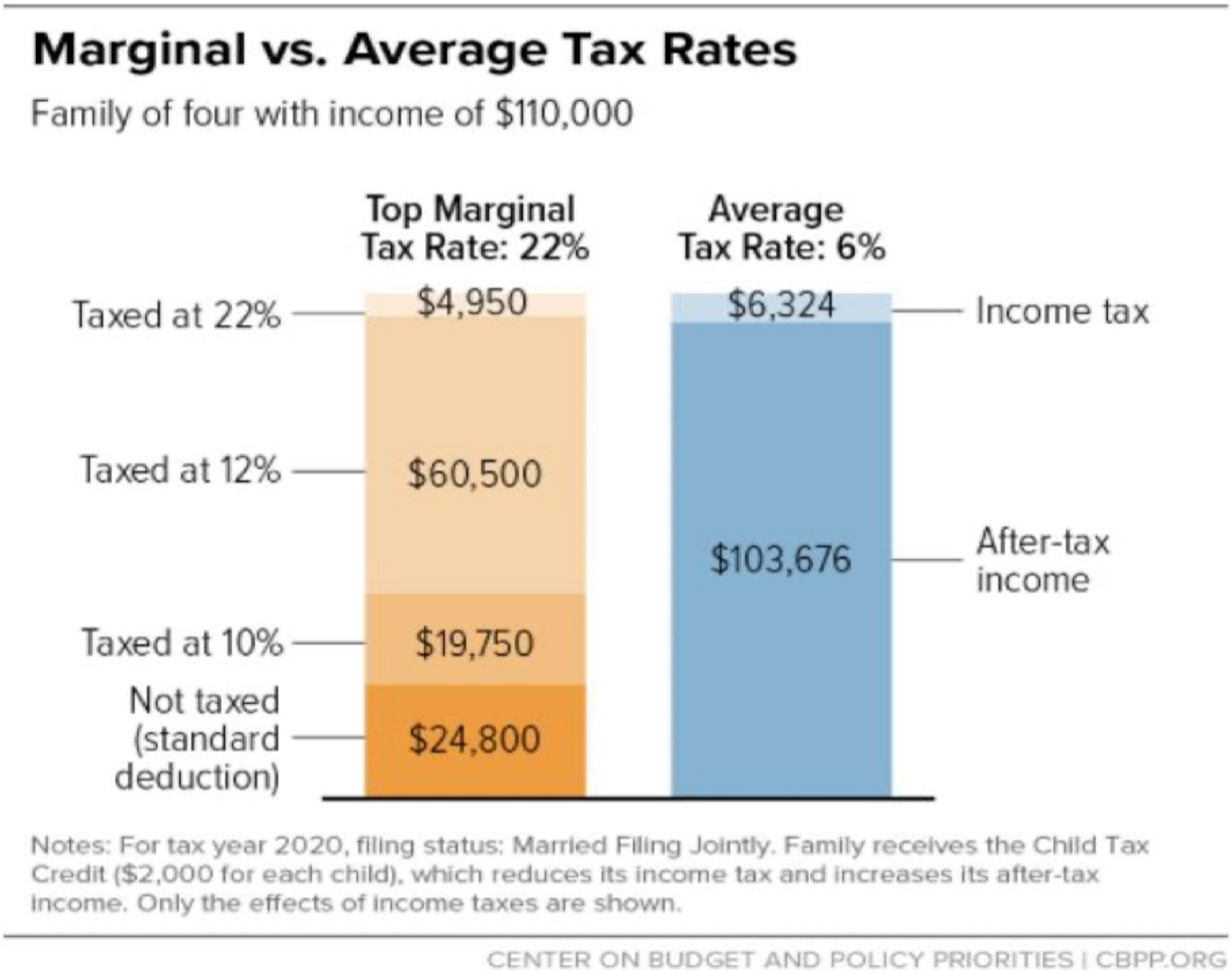
It has been reported that over half of all Americans do not fully understand how their income tax is calculated. Here's a quick primer on how it works.

The single biggest error people make is thinking that you apply the taxpayer's top tax bracket percentage to the total income.

Instead, think of tax rates as brackets that "fill up" with income before moving on to the next bracket. In other words, income is taxed at the rate of the first bracket up to a certain threshold. Income over that threshold is taxed in the second bracket up to another threshold, and so on. In addition, most Americans use the standard deduction, which automatically excludes some of your income from taxation.

In the example below, we look at a married couple with two children with income of $110,000. As you can see, the first $19,750 of income (after the standard deduction) is taxed at 10%, which equals $1,975 in tax owed by this family. The next $60,500 of income is taxed at 12%, which equals $7,260 in tax owed.

Finally, this family's income spills over to the 22% tax bracket, with $4,950 of income taxed at 22%, which equals $1,089 in tax owed. If we add the tax due for all three brackets together, it totals $10,324. Then, child tax credits of $4,000 ($2,000 per child) are deducted and the income tax owed is $6,324. Thus, this family is effectively paying 6% ($6,324 / $110,000) in income tax.



There are currently seven different tax rates: 10%, 12%, 22%, 24%, 32%, 35%, and 37%. **Each rate applies only to a specific bracket of income, rather than to total income.** Also, there are different brackets depending on how you file which is referred to as your 'filing status'. Filing status could be married filing jointly, single, or head of household, to name a few.

WHAT'S MY MARGINAL RATE?

When someone says they are in the 24% bracket they are referring to their 'marginal' rate, or the highest bracket of taxable income. The easiest way to figure out your marginal tax rate is to look at the federal tax brackets and see in which bracket your taxable income ends. In the example above, the family is in the 22% marginal bracket.

WHAT'S MY AVERAGE RATE?

Everyone has an 'average' or 'effective' rate. The average rate is simply the actual percentage of your total taxable income that goes to the IRS. To calculate this rate, you divide your tax liability (what you owe) by your total taxable income.

Generally, marginal rates are used for making decisions about what will happen if your income or deductions increase or decrease. For instance, if you are trying to determine the impact of a specific change in income, such as processing a Roth conversion or charitable gift, your marginal tax rate will typically tell you the answer. If you are trying to determine how much of your income to withhold for taxes, then your effective tax rate may give you a better answer.

Understanding the difference between your marginal tax rate and your average (or effective) tax rate can be an important tax planning tool. Please reach out to your Advisor if you would like to discuss any of the tax planning ideas mentioned in this blog and always remember to consult with your Accountant for tax advice prior to making any changes.