

B Tax Bracket Myths |

By Kevin Flynn, CPA

BEGINNING IN CALENDAR YEAR 2003 AND incorporating the Jobs and Growth Tax Relief Reconciliation Act of 2003, individual income taxpayers are grouped into six different marginal tax-rate brackets for federal purposes: 10%, 15%, 25%, 28%, 33%, or 35%. The marginal tax rate represents the amount of additional tax owed for one dollar of additional income earned. But are the six marginal tax brackets always accurate when describing the actual marginal tax rates? Is 35% really the top marginal tax rate? And is it possible for the actual tax rate to exceed the stated marginal tax bracket rate? The U.S. federal income tax law contains various deductions and credits that phase out as an individual's income increases beyond certain thresholds.

Also, some provisions require the recognition of additional income when other income levels meet certain thresholds. In fact, for many taxpayers, the top marginal tax rate of 35% is a myth. Let's look at the tax situations of various hypothetical individuals, their 2003 marginal tax bracket rates using the six rates provided by Congress, and either their actual 2003 marginal tax rates or their actual 2003 tax rate applied to an increase in income. The situations are designed to show that actual tax rates and marginal tax rates can exceed the stated marginal tax bracket rates.

Situation 1: Jim and Barb, a married couple, own two rental properties, one in the mountains and one at the

shore. Because neither person is a real estate professional, Jim and Barb may deduct up to \$25,000 in losses from the two properties annually, a figure they have had no trouble realizing in recent years. In 2002, the couple's adjusted gross income (AGI) was \$100,000. In 2003, Jim was considering a new job that would increase his salary by approximately \$30,000. Using the 2003 tax-rate schedule, Barb noticed that the salary increase would put the couple

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into the 28% marginal tax bracket. According to IRC §469(i)(3)(A), however, the \$25,000 deduction for real estate rental losses "shall be reduced (but not below zero) by 50% of the amount by which the AGI of the taxpayer for the taxable year exceeds \$100,000." This 50% phaseout rate also eliminates the deduction when AGI

reaches \$150,000. In addition, according to IRC §68(a), itemized deductions are reduced by "the lesser of (1) 3% of the excess of adjusted gross income over the applicable amount, or (2) 80% of the amount of the itemized deductions otherwise allowable for such taxable year." For 2003, the "applicable amount" was \$139,500. Because the real estate rental deduction and the total itemized deduction amounts phase out ratably after AGI reaches the threshold amounts of \$100,000 and \$139,500, respectively, and assuming that Jim and Barb chose to itemize deductions on their tax return, their actual marginal tax rate would become 43%, not 28%, when their AGI fell in the range of \$139,500–\$150,000: $28\% \times (1.00 + .50 + .03)$. If Jim took

the job and his salary increased by \$30,000, the couple would lose \$15,000 of their rental deduction. Their new AGI would be \$145,000, putting them in the range where their marginal tax rate would be 43%.

Situation 2: Craig and Ann, a married couple that file a joint return, have two dependent children in college. One child is a freshman, and the other is a junior. In 2002, the couple's AGI was \$82,000, thus enabling them to qualify for the maximum combined Hope Scholarship and Lifetime Learning Credit amount of \$2,500 provided by IRC §25A. In 2003, Ann was considering a new job that would raise her salary by approximately \$21,000. On one hand, the salary increase wouldn't move the couple out of the 25% marginal tax bracket. On the other hand, the education tax credits begin to phase out when AGI exceeds \$83,000 for a married couple, and they are eliminated when AGI reaches \$103,000. Further, according to IRC §25A(c)(1), the maximum education tax credit amount increases to \$3,500 in 2003. Therefore, the \$21,000 salary increase, plus the elimination of the tax credit, would cause an \$8,750 increase in the couple's tax liability: $(\$21,000 \times .25) + \$3,500$. As a result, the actual marginal tax rate applied to the \$21,000 salary increase is 42% $(\$8,750 / \$21,000)$, which exceeds the couple's marginal tax bracket rate of 25%.

Situation 3: The taxpayers in the previous situations had tax rates that exceeded, or potentially could exceed, the top stated marginal tax bracket rate of 35%. There are other, less extreme situations where the actual tax rate applied to certain income amounts exceeds the taxpayer's stated marginal tax bracket rate. John, for example, is a recent

college graduate working in his first post-college job. He rents a modest apartment and is good about saving what he can so that he will be able to buy a house someday. Each year, John dutifully makes the maximum deductible contribution amount allowed to his traditional IRA, which is his only deduction for AGI. In 2002, John contributed \$3,000 to his IRA and planned to do so again in 2003. John is an active participant in his employer's qualified retirement plan, saving the maximum amount matched by his employer. In 2003, John was being considered for a promotion within the company. The new position would raise his salary from its current level by \$10,000. Considering that his AGI for 2002 was \$40,000, and looking at the tax rates for the single filing status, John noticed that he would remain in the 25% marginal tax bracket. What John might have wanted to consider, however, is that his tax deduction for his annual IRA contribution begins to phase out when his AGI exceeds \$40,000 (according to IRC §219(g)), and it will be eliminated when the AGI reaches \$50,000. Therefore, a \$10,000 salary increase would cause a \$13,000 increase in taxable income—considering that the \$3,000 IRA deduction would be eliminated—and his tax liability would be increased by \$3,250 $(\$13,000 \times 25\%)$. As a result, the actual tax rate applied to John's \$10,000 raise isn't 25%, but 33% $(\$3,250 / \$10,000)$.

Situation 4: Pat graduated from college in the spring of 2002 and began working full-time two weeks later. Her AGI for 2002 was \$15,000, less than what it would typically be considering that she worked full-time for less than the

entire year. In addition, Pat made a \$2,000 contribution to a Roth IRA in 2002, a transaction that earned her a \$1,000 tax credit on her income tax return in accordance with IRC §25B. In 2003, Pat anticipated that her AGI would increase to \$25,000 because she would be gainfully employed during the entire year. As she did in the prior year, Pat made a \$2,000 contribution to her Roth IRA for 2003. Trying to calculate her estimated tax liability for 2003, Pat noticed that she would remain in the 15% tax bracket. What Pat might not have realized is that the \$1,000 credit that she received in 2002 for making the IRA contribution isn't available when her AGI reaches \$25,000. Therefore, the \$10,000 salary increase combined with the elimination of the tax credit would cause a \$2,500 increase in tax liability: $(\$10,000 \times .15) + \$1,000$. As a result, the actual tax rate applied to the \$10,000 salary increase is 25% $(\$2,500 / \$10,000)$, not 15%.

The examples in this article are common situations that occur to taxpayers. They illustrate that the actual and marginal tax rates for additional income can exceed the top stated marginal tax bracket. Thus, the 35% tax rate bracket may truly be a myth for some taxpayers. ■

Kevin Flynn, Ph.D., CPA, is an assistant professor at West Chester University in West Chester, Pa. He can be contacted by phone at (610) 436-3015 or e-mail at kflynn@wcupa.edu.

Anthony P. Curatola is the Joseph F. Ford Professor of Accounting at Drexel University. He may be reached by phone at (215) 895-1453 or e-mail at curatola@drexel.edu.