What is Your Marginal Tax Rate?
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Marginal tax rate is an essential part of tax planning. Enactment of the American Taxpayer Relief Act of 2012 and the application of the net investment income tax, made determination of marginal tax rate much more complex. Current legislative deliberations could cause further changes. This presentation describes and explains this complex topic.

I. Individual Taxpayer Taxes and Tax Rates

A. Overview

This discussion focuses on individual taxpayer federal tax rates. It is important to remember that operations from businesses conducted as partnerships or S corporations are commonly reported by individual taxpayers. The entity chosen and the activities of the owner (passive or active) can cause complications in the application of the law discussed below. While not the primary focus of this discussion, how corporations and shareholders are taxed is very relevant to tax planning seeking to minimize tax. This discussion does not consider state income tax rates.

Individual taxpayer can be subject to the following federal taxes:

- Federal income tax
- FICA / Medicare tax applicable to compensation income
- Self employment tax
- Net investment income tax

Each of these taxes is described below.

B. Federal Income Tax

The federal income tax is imposed on the taxable income of individual taxpayers with the tax determined using graduated progressive rate structure with marginal tax rates from 10% to 39.6%. In calculating taxable income, a variety of deductions are allowed to reduce the tax base. Tax rates are different for married and single taxpayers. Net long term capital gain and qualified dividend income are subject to a special graduated rate structure ranging from 0% to 20%.

C. FICA / Medicare tax Applicable to Compensation Income

The Federal Insurance Contribution Act (FICA) imposes two taxes on income compensating services. Both employees and employers are subject to these taxes. The taxes imposed are equal for the employer and employee as follows:

2013

Compensation	**Employer**	**Employee**	**Total**
$0 - $113, 700	**6.2% - 1.45% = 7.65%**	**6.2% - 1.45% = 7.65%**	**15.4%**
$113,701- $200,000	**1.45%**	**1.45%**	**2.9%**
Over $200,000	**1.9%**	**1.9%**	**3.8%**

2014

Compensation	**Employer**	**Employee**	**Total**
$0 - $117, 000	**6.2% - 1.45% = 7.65%**	**6.2% - 1.45% = 7.65%**	**15.4%**
$117,001- $200,000	**1.45%**	**1.45%**	**2.9%**
Over $200,000	**1.9%**	**1.9%**	**3.8%**

D. Self Employment Tax

In addition to the federal income tax, self employed taxpayers must pay a self employment tax comparable to the FICA / Medicare tax paid by employers and employees. The tax is imposed on self employment income as follows:

2013

Self Employment Income	**Total**
$0 - $113, 700	**15.4%**
$113,701- $200,000	**2.9%**
Over $200,000	**3.8%**

2014

Compensation	**Total**
$0 - $117, 000	**15.4%**
$117,001- $200,000	**2.9%**
Over $200,000	**3.8%**

E. Net Investment Income Tax

Many U.S. citizens and residents are subject to a 3.8% tax on “net investment income”. For taxpayers subject to the tax, the tax is 3.8% of the “net investment income”. The tax is only imposed on taxpayers with “modified adjusted gross” in excess of a “threshold amount” which is $200,000 for unmarried taxpayers (including head of household) ; $250,000 for married jointly and $125,000 for married filing separately. The amount subject to tax is limited to the excess over the “threshold amount. Limited deductions are available in the calculation of “net investment income”.

II. Why is Marginal Tax Rate Important?

The focus of this discussion is to provide a better understanding of marginal tax rates a increasingly complex intersection of multiple taxes. Let’s begin this discussion by asking why marginal tax rate is important. More specifically, what decisions are best made only if the marginal tax rate is understood and included in the analysis leading to the decision.

Yearend tax planning frequently starts with the question of “where are we”. This year’s events have presented the possibility that tax will be paid. The focus becomes “what can we do” to reduce tax and how much tax can be saved if we act. The higher a taxpayer’s marginal tax rate, the greater the incentive to act.

Possible situations where marginal tax rate matter are:

Making an expenditure which will reduce the tax base and reduce tax.
The marginal tax rate on the reduction in tax base will determine the tax savings from making the expenditure

Earning income this year.
If the income is earned in the current year a tax will be due equal to the marginal tax rate times the increase in the tax base

Investments.
When evaluating investment alternatives, the after tax cost must be considered. Tax considerations can alter the timing and the structure of the investment and in some cases cause the investment not to be made.

Use of a trust .
For personal wealth management trusts are common devices to make "controlled gifts" to family members. Trusts can be taxpayers making the trust's marginal tax rate important.

Long term planning for privately held businesses.
For privately held businesses which are conducted as partnerships or S corporations making the S election, individual marginal tax rates can determine the tax imposed on the current operation of the business. In the long term, individual marginal tax rates will be important if the business is sold.

III. What Happened in 2013?

The net investment income tax was first effective in 2013. An extra .9% FICA/ Medicare tax on wages was first applicable in 2013. In 2013, the individual income tax rates were changed with the result being higher marginal tax rates applicable to the highest income taxpayers and a special graduated rate system applicable to long term capital gains and dividend income. The 2013 version of each of these "new" taxes is discussed below including how they affect the marginal tax rate in several different situations.

A. Tax on Net Investment Income

Many U.S. citizens and residents are subject to a 3.8% tax on "net investment income". For taxpayers subject to the tax, the tax is 3.8% of the "net investment income". The tax is only imposed on taxpayers with "modified adjusted gross" in excess of a "threshold amount" which is $200,000 for unmarried taxpayers(including head of household) ; $250,000 for married jointly and $125,000 for married filing separately. The amount subject to tax is limited to the excess over the "threshold amount. Limited deductions are available in the calculation of "net investment income".

1. <u>Who Pays the Tax on Net Investment Income?</u>

The 3.8% tax potentially applies to US citizen or resident individuals, estates and trusts.

The following trusts are not subject to the tax :

a. Trusts when all of the unexpired interests are devoted to charitable purposes
b. Trust exempt from tax under Section 501
c. Charitable remainder trusts, and
d. Grantor Trusts (income reported by grantor).

2. <u>Definition of Net Investment Income</u>

Net investment income is defined to include :

a. interest
b. dividends
c. annuities
d. royalties and rents
e. other gross income that is "passive" or "trading income"

f. gain attributable to property that is held in a trade or business that is not "passive" or a "trading"

These types of income are not investment income if they are derived in the ordinary course of a business that is not "passive" or a "trading activity". Note this type of income reported by an individual is usually subject to the self employment tax.

This income is reduced by deductions allocable to the income. Any deductions used to reduce self employment income cannot be used to reduce net investment income.

3. <u>Calculation of the Tax</u>

The tax is 3.8% of the lesser of the "net investment income" or the excess of "modified adjusted gross income" over the threshold amount which is $200,000 for unmarried taxpayers including head of household) ; $250,000 for married jointly and $125,000 for married filing separately. Note that taxpayers who have net investment income but have "modified adjusted gross income less that the "threshold amount" are not subject to the 3.8% tax.

B. Federal Income Tax Rates Applicable to Taxable Income

In 2013 Congress changed the tax rates applicable to taxable income of individual taxpayers. The tax rates applicable to single and married filing jointly filing statuses are included below . The marginal tax rates begin at 10% and reach the maximum rate of 39.6%. For 2013 the 39.6% tax rate is applicable to single taxpayer taxable income in excess of $400,000. For married filing jointly, the 39.6% tax rate begins at $450,000.

C. Federal Income Tax Rates Applicable to Long Term Capital Gains and Dividend Income

In 2013, Congress raised the maximum tax rates applicable to net long term capital gain and qualified dividend income. A complex graduated rate structure was created which causes the maximum applicable rate to be either 0% , 15%, or 20% depending the amount of the taxpayer's taxable income other than long term capital gains and qualifying dividend income. The rate structure is described below.

In 2013, for unmarried taxpayers with "other taxable income" equal to or in excess of $400,000 ($450,000 for married filing jointly), the applicable marginal tax rate is 20%.

	Maximum tax Rate applicable to NLTCG
If the NLTCG will be taxed at a rate below 25%	**0%**
If the NLTCG will be taxed at a rate below 39.6%	**15%**
If the NLTCG will be taxed at 39.6%	**20%**

Married Jointly	**2013**	**2014**
Below 25%	**$72,500**	**$73,800**
Below 39.6%	**$450,000**	**$457,600**

Unmarried	**2013**	**2014**
Below 25%	**$ 36,250**	**$36,900**
Below 39.6%	**$400,000**	**$406,750**

D. Tax on Wages of High Compensation Taxpayers

In 2013, Congress modified the FICA /Medicare tax applicable to wages in excess of $200,000. In 2013, wages in excess of $200,000 are subject to a 3.8% combined tax burden with 1.9% payable by the employer and an additional 1.9% payable by the employee. This tax is payable on wages without any allowable deductions.

E. Aggregate Tax Cost – Wages

Wages are subject to both the federal income tax and the FICA / Medicare tax . In calculating the federal tax can be reduced by appropriately claimed deductions. These deductions do not reduce the FICA / Medicare Tax. Considering only the employee's share of FICA/ Medicare the marginal tax rates can range from 7.65% to 47.25%(7.65% + 39.6%). Considering the employer's share of FICA/ Medicare this range is 15.3% to 54.9% (39.6% + 15.3%). Highly compensated individuals are likely subject to an aggregate marginal tax rate of 41.5% (39.6% + 1.9%). Considering both the employer and employee share of FICA/ Medicare tax these taxpayers are subject to a marginal tax rate of 43.4% (39.6% + 3.8%).

A common tax planning device for privately held corporate businesses is to compensate shareholders employees to avoid " double taxation" . This corporate deduction could save corporate tax by as much as 35%. If in 2013 the shareholder employee has compensation in excess of $200,000 and taxable income in excess of $400,000 ($450,000 if married filing jointly), the 43.4% aggregate marginal tax rate on compensation result s in an increased marginal tax cost of 8.4% (43.4% - 35%). This is the price of "avoiding double tax".

Note that tax planning using deductions to reduce taxable income will only produce a tax savings based on the federal income tax marginal tax rate.

F. Aggregate Tax Cost – Self Employment Income

Self employment income is subject to both the federal income tax and the self employment tax . Both federal tax and the self employment tax can be reduced by appropriately claimed deductions related to the self employment activity. The marginal tax rates on self employment income can range from 15.3% to 54.9%.(39.6% + 15.3%). Individuals with large amounts of self employment income are likely subject to an aggregate marginal tax rate of 43.4% (39.6% + 3.8%).

Using an S corporation with reasonable compensation and dividends, is currently a planning option to reduce the amount subject to the self employment tax. There has been legislation considered to make S corporation taxable income subject to self employment tax in a manner similar to partnerships.

G. Aggregate Tax Cost – Interest and Other Investment Income

Interest and other investment income could be subject to both the federal income tax and the 3.8% tax on net investment income. Since the 3.8% tax does not apply to taxpayer with modified adjusted gross income equal to or less than $200,000 for unmarried taxpayers (including head of household) ; $250,000 for married jointly and $125,000 for married filing separately; lower income taxpayers will have investment income taxed at marginal rates ranging from 10% to 33% depending on their taxable income (likely less than the "modified adjusted gross income). In 2013 unmarried taxpayers with taxable income over $400,000 will be subject to a marginal tax rate of 43.4% (39.6% + 3.8%) on the portion of their taxable income which is interest or other investment income.

A common tax planning device for privately held corporate businesses is to include shareholder loans to the corporation. Interest paid by the corporation is deductible to the corporation and income to the shareholder / creditor. This corporate deduction could save corporate tax by as much as 35%. If in 2013 the shareholder creditor has modified adjusted gross income in excess of $200,000 ($250,000 married filing jointly) and taxable income in excess of $400,000 ($450,000 if married filing jointly), the 43.4% aggregate marginal tax rate on interest result s in an increased marginal tax cost of 8.4% (43.4% - 35%). This is the price of "avoiding double tax".

H. Aggregate Tax Cost – Dividends and Long Term Capital Gain

Dividends and long term capital gains can be subject to aggregate tax rates that range from 0% to 23.8%. taxpayers with taxable income less than $36,250 ($72,500 married filing jointly) will owe no tax on net long term capital gain and dividend income. In 2013, taxpayers with taxable income in excess of $400,000 ($450,000 married filing jointly) will be subject to both the net investment income tax of 3.8% and to the federal income tax at a 20% federal income tax marginal tax rate. The aggregate marginal tax rate is 23.8%.

I. Aggregate Tax Cost – "Marriage Penalty"

The "threshold amounts" for the net excess passive income and the design of the 2013 federal income tax rate structure contain potential for a marriage penalty result.

Net investment income is taxed at 3.8% to the extent it exceeds "modified AGI" of $200,000 for an unmarried individual. For a married couple filing jointly, the threshold amount is $250,000. If two individuals each had $200,000 of modified adjusted gross income, the net excess investment income tax could be avoided. If these two persons were married, it is possible that $150,000 ($400,000 - $250,000) could be subject to the 3.8% tax making a potential "marriage penalty" of $5,700 ($150,000 x 3.8%).

The 2013 federal income tax rates also contain a potential "marriage penalty" possibility for high taxable income taxpayers. If in 2013 two persons each had taxable income of $400,000. Two single taxpayers would each owe tax of $116,164. None of the taxable income is taxed at a 39.6% marginal tax bracket. If these two persons were married filing jointly, their total tax burden is $264,446 ($125,846 + 39.6% ($800,000 - $450,000)). There is $350,000 subject to tax at 39.6%. Two single taxpayers incur a federal income tax of $232,328 making a marriage penalty of $32,118 ($264,446 - $232,328). Since all taxable additional taxable income earned will be subject to 39.6% in either situation, this is the maximum penalty.

IV. Possible future legislation

Discussion of possible future changes in the tax law is simultaneously futile and important. The discussion below is not a prediction, but instead an identification of areas where past behavior indicates areas of possible change.

1. **Individual Tax rate changes**
   The 2013 individual tax rate changes seem to make a change in individual marginal tax rates not very likely
2. **S Corporation Self Employment Advantage**
   As discussed above, self employment tax savings can be gained by the use of an S corporation with the minimum reasonable compensation of the shareholders and dividends . Legislation has been proposed in the past to eliminate this treatment which is more favorable than what is possible for partnerships.

3. **FICA / Medicare / Self Employment Rates and Bases**
   There have been discussions advocating increasing the amount of wages and self employment income that is subject to the higher self employment tax and FICA / Medicare rates (combined 15.3%). This could become more necessary as the social security and Medicare systems feel the financial stress of an aging population.

4. **Corporate Tax Rates**
   There have been significant discussion regarding lowering the marginal tax rates applicable to corporate tax able income. If corporate tax rates are cut to 25%, there would be an increased current income disadvantage of operating businesses as a partnership or an S corporation.

V. Other Information

A. Income Tax Rate Schedules – 2014 and 2013

Income Tax Rate Schedules – 2014

SINGLE TAXPAYER – 2014

If taxable income is:	The tax is:
Not over $9,075	10% of the taxable income
Over $9,075 but not over $36,900	$907.50 plus 15% of the excess over $9,075
Over $36,900 but not over $89,350	$5,081.25 plus 25% of the excess over $36,900
Over $89,350 but not over $186,350	$18,193.75 plus 28% of the excess over $89,350
Over $186,350 but not over $405,100	$45,353.75 plus 33% of the excess over $186,350
Over $405,100 not over $406,750	$117,541.25 plus 35% of the excess over $405,100
Over $406,750	$118,118.75 plus 39.6% of the excess over $406,750

MARRIED JOINTLY - 2014

If taxable income is:	The tax is:
Not over $18,150	10% of the taxable income
Over $18,150 but not over $73,800	$1,815 plus 15% of the excess over $18,150
Over $73,800 but not over $148,850	$10,162.50 plus 25% of the excess over $73,800
Over $148,850 but not over $226,850	$28,925 plus 28% of the excess over $148,850
Over $226,850 but not over $405,100	$50,765 plus 33% of the excess over $226,850
Over $405,100 but not over $457,600	$109,587.50 plus 35% of the excess over $405,100
Over $457,600	$127,962.50 plus 39.6% of the excess over $457,600

Income Tax Rate Schedules – 2013

SINGLE - 2013

If taxable income is:	The tax is:
Not over $8,925	10% of taxable income
Over $8,925 but not over $36,250	$892.50 plus 15% of the excess over $8,925
Over $36,250 but not over $87,850	$4,991.25 plus 25% of the excess over $36,250
Over $87,850 but not over $183,250	$17,891.25 plus 28% of the excess over $87,850
Over $183,250 but not over $398,350	$44,603.25 plus 33% of the excess over $183,250
Over $398,350 but not over $400,000	$115,586.25 plus 35% of the excess over $398,350
Over $400,000	$116,163.75 plus 39.6% of the excess over $400,000

MARRIED JOINTLY - 2013

If taxable income is:	The tax is:
Not over $17,850	10% of taxable income
Over $17,850 but not over $72,500	$1,785 plus 15% of the excess over $17,850
Over $72,500 but not over $146,400	$9,982.50 plus 25% of the excess over $72,500
Over $146,400 but not over $223,050	$28,457.50 plus 28% of the excess over $146,400
Over $223,050 but not over $398,350	$49,919.50 plus 33% of the excess over $223,050
Over $398,350 but not over $450,000	$107,768.50 plus 35% of the excess over $398,350
Over $450,000	$125,846 plus 39.6% of the excess over $450,000

B. Federal Income Tax Rates Applicable to Long Term Capital Gains and Dividends

	Maximum tax Rate applicable to NLTCG
If the NLTCG will be taxed at a rate below 25%	0%
If the NLTCG will be taxed at a rate below 39.6%	15%
If the NLTCG will be taxed at 39.6%	20%

Married Jointly	2013	2014
Below 25%	$72,500	$73,800
Below 39.6%	$450,000	$457,600

Unmarried	2013	2014
Below 25%	$ 36,250	$36,900
Below 39.6%	$400,000	$406,750

C. FICA / Medicare Tax Rate Schedule

2013

Compensation	Employer	Employee	Total
$0 - $113, 700	6.2% - 1.45% = 7.65%	6.2% - 1.45% = 7.65%	15.4%
$113,701- $200,000	1.45%	1.45%	2.8%
Over $200,000	1.9%	1.9%	3.8%

2014

Compensation	Employer	Employee	Total
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$117,001- $200,000	1.45%	1.45%	2.8%
Over $200,000	1.9%	1.9%	3.8%

D. Self Employment Tax Rate Schedule

2013

Self Employment Income	Total
$0 - $113, 700	15.4%
$113,701- $200,000	2.8%
Over $200,000	3.8%

2014

Compensation	Total
$0 - $117, 000	15.4%
$117,001- $200,000	2.8%
Over $200,000	3.8%