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## THE DREADED HIGHER TAX BRACKET

When I first left medicine and dove into the world of finance, there were a couple of amazing “AHA!” moments; and I love to share them. One of them was a very simple issue – marginal versus effective tax rates. That’s right. We are going to talk taxes. This is especially pertinent in an era of potential tax reforms.

Taxes are about the driest, least exciting, and most complex topic I have studied. That’s serious coming from a Pathologist! As I learned more about income taxes, I realized that most of my clients were equally disinterested or confused by some basic tax principals. They either hadn’t come across it in their use of TurboTax or their accountant just hadn’t outlined them. And, goodness knows we aren’t taught this stuff in school. So, forgive me if you were already in the know, but I want to make sure everyone else gets caught up.

Clients often express a fear of income taxes – nobody likes them! One of the common complaints I hear is that people are concerned about getting bumped into a higher federal income tax bracket. Let’s start with this – if you are in a higher tax bracket, congratulations! That means you made more money! More money is good.

Entering a higher tax bracket means that your marginal tax rate has increased. So, if you went from making \$100,000 a year to \$160,000 a year you went from the 25% marginal tax bracket to the 28% bracket. Noooooo!

Here is where the marginal rate is important. All the money that you made up to \$153,100 is still taxed at the lower rates. Here is an illustration:

\$0-\$18,650 = 10%

\$18,651-\$75,900 = 15%

\$75,901-\$153,100 = 25%

$$\$153,101 - \$233,350 = 28\%$$

A person earning \$160,000 will pay 10% in taxes on the first \$18,650 earned; 15% on the next \$57,250; and 25% on the next \$77,200 earned. So, you only pay 28% on the last \$6,900 earned as it is the only amount above the \$153,100 threshold for the 25% rate. The actual amount of tax that you will pay on all your income is the effective rate, which considers the lower tax rates that you are paying on the dollars earned before you get to the highest rate, your marginal tax rate.

In this example, the effective tax rate would be:

$$\begin{aligned} \$18,650 \times 10\% &= \$1,865 \\ \$57,250 \times 15\% &= \$8,587.50 \\ \$77,200 \times 25\% &= \$19,300 \\ +\$6,900 \times 28\% &= \$1,932 \\ \hline \$31,684.50 &= 19.8\% \end{aligned}$$

There, doesn't 19.8% sound better than 28%? That is your effective tax rate and represents the amount you are actually paying in federal income taxes. The horrible 28% is your marginal tax rate and is the absolute top tier at which a portion of your income is taxed.

Even those who make over \$470,000 a year and hit the highest tax rates of 39.6% are paying lower rates on much of their income. It creates a bit more level playing field.

Congratulations! We both made it through an article about taxes. I hope you learned something new or will take the time to explain this to someone else in your family or with whom you work

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