



Your Tax Bracket

"What's my tax bracket?" is a very important—and commonly asked—question. First, it lets you know how much tax you must pay the government, and second, it affects how much after-tax savings certain deductions can generate, as well as how much after-tax return certain investments generate, under current 2000 rules.

In actual fact, there are two important tax brackets for everyone:

Your effective, Overall Tax Bracket, and your Marginal Tax Bracket.

Your Overall Tax Bracket

This is exactly as it sounds; it's an average figure based on the total amount of tax you pay compared to your gross taxable income. Thus, if you paid \$5,000 in federal taxes, and your gross taxable income was \$33,400 as a married filer, your Overall Tax Bracket would be 15%. In effect, you paid 15% of your gross taxable income to the federal government. So, everything else being equal, you could budget that amount as your reserve for federal taxes.

The same type of analysis applies for state income taxes paid. If your state tax amounted to \$1,000 in the above example, your state Overall Tax Bracket would be 3% before allowance for federal deductibility of these state taxes.

Your Marginal Tax Bracket

This bracket is very important for tax planning purposes. In effect, it is the tax rate you pay on the last dollar of net taxable income, hence the term "marginal." Under our current tax laws, there are several tax brackets; the more money you make, the higher the tax for that portion—or bracket—of money. For instance, a single individual with a taxable income of \$65,000 would pay federal tax as follows: 15% on the first \$25,750, 28% on the next \$36,700, and 31% on the remaining \$2,550, based on the 1999 tax rate schedules.

Thus, in this example, the marginal bracket would be 31%, and the taxpayer would pay 31 cents on every extra dollar earned above the \$62,450 level already being taxed. It also means this taxpayer would save 31 cents on every extra dollar of tax deductions at this level. Examples of these allowable federal deductions are such items as interest expense, donations, taxes, medical, and miscellaneous business expenses, to name a few. Taxpayers who also have deductions in such areas as rental property, capital losses, retirement plan deductions, and businesses of their own follow the same pattern.

Finally, this marginal bracket is important in evaluating the true return on different types of investments. By analyzing the gross income from the investment vs. the actual, after-tax yield, a "common denominator" can be found among various investments. So, if the taxpayer in the example we used made an extra investment that yielded 10%, the actual, after-tax yield on this from a marginal tax bracket standpoint would be 10% less the 31% tax, or 6.9%.



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Let's use dollars to make the conceptualization easier. Assume you make an investment that costs \$10,000 and returns \$1,000(10%) in taxable income. If your marginal tax rate is 31%, then \$310 must be paid in taxes, leaving \$690, or 6.9%.

Again, the same type of analysis applies to state taxes paid on a marginal basis. This becomes especially important from an after-tax analysis in comparing taxable vs tax-free investments such as municipal bonds, or U.S. obligations such as treasuries.

In fact, the state marginal tax bracket can be defined even more technically when you assume that state income taxes will be deductible on the federal tax return. In this case, the state taxes are actually less because of the federal tax savings due to their deductibility. As an example, if your state marginal tax bracket were 4%, and your federal marginal tax bracket were 31%, then the actual state, after-federal-tax marginal bracket would be 3.69% which is the 4% less the federal tax savings of 31 cents on the dollar of deductions.

As you can see, the higher your income, the higher the marginal tax rate, and the more important this after-tax analysis becomes when it concerns your deductions, or your investments.