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Teaching and educational notes

Federal income tax laws that cause individuals' marginal and statutory tax rates to differ

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A B S T R A C T

This article presents a "phaseouts table" as a tax educational tool. The table compiles and summarizes the phaseouts of and limitations on deductions, credits, exclusions from income, and allowed contributions for individual U.S. federal income taxpayers in 2013. Phaseouts can cause individual taxpayers' marginal tax rate (MTR) to be higher than their statutory tax rate (STR) (i.e., "bracket" based on taxable income). For each phaseout, the table includes how the phaseout works, the adjusted gross income (AGI) range for the phaseout, and the related formula to compute MTR, given STR. The table is appropriate for any course that covers either U.S. federal income taxation of individuals or tax planning. (The phaseouts table is updated annually and is available upon request from the author.) The remainder of the article is a teaching resource, explaining how to compute the specific impact on MTR of each of several example phaseouts. Together, the phaseouts table and article enable U.S. tax instructors to assist students in learning about phaseouts in an integrated, comprehensive manner.

1. Introduction

Individual U.S. taxpayers whose adjusted gross income (AGI) is high enough to cause a partial phaseout have a marginal tax rate (MTR) that is higher than their statutory tax rate (STR) bracket

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Table 1
Impact of student loan interest deduction phaseout on marginal tax rate (filing status is single; year is 2013).

		Additional Income of $1000	Relevant Difference
Income	$60,000	$61,000	$1000
Student loan interest deduction	−2500	−2333	167
AGI	57,500	58,667	1167
Standard deduction	−6100	−6100	
Personal exemption	−3900	−3900	——
Taxable income	47,500	48,667	1167
Tax (from tax rate schedule)	$7804	$8096	$292

(Geisler & Larkins, 2003).[1] Altshuler and Goldin (2009, p. 335) find that in 2009 MTR was greater than STR for 32% of U.S. individual taxpayers. This finding suggests almost one out of three individual taxpayers in 2009 had one or more tax benefits partially phased out. Table 1 contains an illustration of such a taxpayer.

Table 1 assumes a single taxpayer pays deductible student loan interest of $2500 in 2013, that the taxpayer takes the standard deduction instead of itemizing deductions, and that AGI before the student loan interest deduction is $60,000—the beginning of the phaseout range. The first column of Table 1 contains these facts and summarizes the taxpayer's income, deductions, and federal income tax. If AGI were any higher, the taxpayer would not receive the full student loan interest deduction. The second column assumes ordinary income is higher by $1000, so the student loan interest deduction is lower because it is reduced by the partial phaseout. Both changes affect the amount of federal income tax. The third column contains the differences between the first two columns.

Under the 2013 tax-rate schedule, a single individual with taxable income over $36,250, but not over $87,850, is in the 25% STR bracket. Comparing tax before the additional $1000 of ordinary income to tax after such income, however, shows an increase of $292. Besides the $250 increase in tax liability caused by the additional income of $1000, the other $42 is caused by the phaseout of $167 of student loan interest deduction for this taxpayer. The $292 net tax increase divided by the increase in income of $1000 results in a 29.2% MTR.

Altshuler and Goldin (2009, 335) also found that for 2009 millions of U.S. taxpayers had one or more full phaseouts of tax breaks but no partial phaseouts. For such taxpayers, MTR is the same as STR. The National Taxpayer Advocate's (NTA) "2008 Annual Report to Congress" states that "more than half of all individual tax returns filed each year are affected by [one or more partial or full] phaseout[s]." The report also states, "The most serious problem facing taxpayers is the complexity of the tax code." The report notes that phaseouts are one cause of the complexity and recommends the repeal of, or at least the simplification of, phaseouts. Former President George W. Bush's Advisory Panel on Federal Tax Reform (2005) also recommended "eliminat[ing] almost all of these phaseouts" for the purpose of simplicity. President Barack Obama's Economic Recovery Advisory Board's "Report on Tax Reform Options" (2010) was not prescriptive, but it consistently criticized the complexity resulting from both so many phaseouts being in the law and all of them having different AGI ranges where the phaseouts occur.

A student learning the U.S. federal income tax laws that affect individuals must deal with this complexity. Using the phaseouts table in this article (Table 2) reduces the complexity. The table contains

[1] Consistent with a Joint Committee on Taxation report in 1998 on MTRs (discussed later in the article), "(effective) marginal tax rate" refers to the increase in tax on an increase in income of $1. To ensure that an increase in income of $1 increases tax, we assume that tax is always computed using the federal tax rate schedules, not the tax tables, and that tax can be in cents (i.e., is not rounded to the nearest dollar). Given a taxpayer's filing status, this article refers to the tax rate bracket that the taxpayer's amount of taxable income is inside as the "statutory tax rate." For 2013, such rate is either 0%, when there is no taxable income, or 10%, 15%, 25%, 28%, 33%, 35%, or 39.6%—the seven percentages in the individual tax rate schedules. If a change in income is from either long-term capital gain or qualified dividend income, the statutory tax rate can be 0%, 15%, or 20%. If the taxpayer is subject to the alternative minimum tax, the statutory tax rate is either 26% or 28%. All of these STRs ignore the 3.8% Medicare tax on net investment income in excess of a threshold amount.