

## Marginal vs. Effective Tax Rates - Transcript

**Tom Mullooly:** In episode 237, we cover the difference between marginal tax rate and effective tax rate. I'm amazed at how many people don't know the difference.

Welcome to the Mullooly Asset Show. I'm your host, Tom Mullooly, and this is episode number 237. Thanks for tuning in. Lots of confusion and people using the wrong terminology when we talk about tax rates, the marginal rate versus the effective rate. We want to take a moment or two and just take the lampshade off the guy at the party.

The marginal tax rate is the tax rate that's charged on the last dollar of earnings that you have. If you are well into the top tax bracket and lots of people think they are, but they're not, then you should use that rate for planning, knowing your tax rate's really important for us because we're doing planning work for clients. The top tax bracket on the federal tax tables right now is 37%. Once you're in that tax bracket, you need to understand that every dollar of earnings will now be taxed at 37%, but that doesn't mean all the money's been taxed at 37%. Let's clear the air on some of these things.

To be in the 37% tax bracket, you need taxable income, your adjusted gross income. We're talking about taxable income, not your gross income. Taxable income, if you're married, filing jointly of \$622,000. If you're a single filer, that's \$518,400, that's a lot of money and it's again, not the gross. It's your adjusted gross income, your taxable income.

There are seven tax brackets at the moment. From time to time, we're going to have 12 tax brackets. Other times we're going to have three. Tax brackets start at 10% and they move all the way out to 37%. A single filer, as we mentioned a moment ago, gets to the 37% tax bracket with \$518,400 of taxable income.

I want to give you an example. Remember that 518,400. Let's talk about a single filer who's got \$520,000 of taxable income. That taxpayer is going to pay 37% tax on only what's over the 518,400. Again, if he earned \$520,000 in taxable income, then the 37% tax rate only applies to the last \$1,600 that this person owned. The marginal tax bracket or the marginal rate is the top rate on the last dollar of earnings.

Now by comparison, the effective tax rate is way more useful for most tax filers, probably more than 90% of tax filers. There's a couple of really simple ways to know what your effective tax rate is and that's your... effective is a good term, but actual would probably be better. The first way to know what your effective tax rate is, if your accountant does your taxes for you, they're likely sending you a report and they're going to tell you on the front page what your effective tax rate is. The second way, super simple. If you've got a calculator or a pen and paper, just go to your tax return, look at the line that says, "This is your total tax." In 2020, it's on page two, it's line number 24. Take that total tax, take that amount and divide it into your adjusted gross income. Now again, in 2020, look on line 11. You're going to take the number on line 24, divide it into the number on line 11, that result, that percentage is your effective tax rate.

We just went through some numbers for a client who, according to his marginal tax rate, he's in the 32% tax bracket, his actual effective tax rate, 19%. Your effective tax rate, your effective rate is going to be in many cases, a lot lower than people even expect.

This doesn't even take into consideration capital gains, which are a completely different tax bracket. They start at zero and go out to 20%. Occasionally you're going to find an adjustment that came through in the last tax law changes, but you need to understand what your marginal rate is. That's what the last dollar gets charged versus what your effective rate is. Your effective rate is, most times, going to be a lot less than people expect.

That's the story for episode 237. Thanks again for tuning in. See you next time.