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The $250,000 Threshold: How does it work?

By
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President Obama's proposal to let the Bush tax cuts expire for married taxpayers making over $250,000 and single taxpayers making over $200,000 sounds simple enough. If you make less than those amounts, nothing changes; if you make more, you pay the old Clinton-era tax rates. Right?

As with anything related to the federal income tax code, things are much more complicated than they seem. For one thing, the Bush tax cuts included much more than just marginal rate reductions—they also changed the way dividend income is taxed, reduced capital gains tax rates, and phased out various limitations on exemptions and deductions for upper income taxpayers. Additionally, marginal tax rates apply to taxable income, while President Obama's thresholds apply to adjusted gross income (AGI). Finally, the president first proposed those $200,000/$250,000 thresholds back in 2009; using the same numbers four years later in 2013 would cause this tax increase to affect significantly more taxpayers than initially intended because of inflation, and the official proposal in his 2013 budget indexes those thresholds using a 2009 base year. Thus, when President Obama talks about letting the Bush tax cuts expire for families earning over $250,000 and single filers earning over $200,000, he really means $267,000 and $213,600, based on our projections.

The marginal rate increases are relatively straightforward, but only if one knows the difference between taxable income and AGI. Taxable income is simply AGI minus personal exemptions (projected to be $3,900 per dependent in 2013, plus an additional $3,900 for the head of the household) and deductions (in 2013, projected to be a minimum of $6,100 for single filers and $12,200 for married filers, plus more if the taxpayer itemizes.) So for an AGI of $267,000 (which is the $250,000 threshold adjusted for inflation to 2013), the applicable taxable income threshold is $267,000 - $12,200 - (2 x $3,900): that's subtracting the standard deduction for married filers and two personal exemptions (one for each spouse.) That comes out to $247,000.

Under current policy, there are six taxable income brackets—10%, 15%, 25%, 28%, 33%, and 35%. The president's proposal would let part of the 33% tax bracket and the entire 35% tax bracket rise to Clinton-era tax rates: 36% and 39.6%.[1] The split in the 33% tax bracket (where the upper part goes up to 36%) is set to

[1] Office of Management and Budget, *The President's Budget for Fiscal Year 2013: Analytical Perspectives*, at 201, http://www.whitehouse.gov/sites/default/files/omb/budget/fy2013/assets/spec.pdf. *See also* Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2013 Revenue Proposals,* at 70, http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2013.pdf.

be the number calculated above: $247,000. (The same calculation for single filers comes out to $203,600.) So the marginal tax rates on taxable income under each scenario are as follows:

<table>
<tr><th></th><th colspan="2">Tax Cuts Expire (2013 projected parameters)</th><th colspan="2">Current Policy (2013 projected parameters)</th><th colspan="2">Obama Proposal (2013 projected parameters)</th></tr>
<tr><td rowspan="7">Single</td><td rowspan="2">$0 to $36,250:</td><td rowspan="2">15%</td><td>$0 to $8,950:</td><td>10%</td><td>$0 to $8,950:</td><td>10%</td></tr>
<tr><td>$8,950 to $36,250:</td><td>15%</td><td>$8,950 to $36,250:</td><td>15%</td></tr>
<tr><td>$36,250 to $87,850:</td><td>28%</td><td>$36,250 to $87,850:</td><td>25%</td><td>$36,250 to $87,850:</td><td>25%</td></tr>
<tr><td>$87,850 to $183,200:</td><td>31%</td><td>$87,850 to $183,200:</td><td>28%</td><td>$87,850 to $183,200:</td><td>28%</td></tr>
<tr><td rowspan="2">$183,200 to $398,350:</td><td rowspan="2">36%</td><td rowspan="2">$183,200 to $398,350:</td><td rowspan="2">33%</td><td>$183,200 to $203,600:</td><td>33%</td></tr>
<tr><td>$203,600 to $398,350:</td><td>36%</td></tr>
<tr><td>$398,350+:</td><td>39.6%</td><td>$398,350+:</td><td>35%</td><td>$398,350+:</td><td>39.6%</td></tr>
<tr><td rowspan="9">MFJ</td><td rowspan="2">$0 to $60,550:</td><td rowspan="2">15%</td><td>$0 to $17,900:</td><td>10%</td><td>$0 to $17,900:</td><td>10%</td></tr>
<tr><td rowspan="2">$17,900 to $72,500:</td><td rowspan="2">15%</td><td rowspan="2">$17,900 to $72,500:</td><td rowspan="2">15%</td></tr>
<tr><td rowspan="2">$60,550 to $146,350:</td><td rowspan="2">28%</td></tr>
<tr><td>$72,500 to $146,350:</td><td>25%</td><td>$72,500 to $146,350:</td><td>25%</td></tr>
<tr><td>$146,350 to $223,050:</td><td>31%</td><td>$146,350 to $223,050:</td><td>28%</td><td>$146,350 to $223,050:</td><td>28%</td></tr>
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<tr><td>$247,000 to $398,350:</td><td>36%</td></tr>
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Things get more complicated when you look at other aspects of the Bush tax cuts—capital gains and dividends, for example. Currently, capital gains are taxed at a top rate of 15%, whereas under President Clinton they had been taxed at 20%. President Obama proposes to tax capital gains at 20%, but only for taxpayers whose income is above his threshold. The way that works in practice is this: take the lesser of your taxable income over the applicable taxable income threshold and your total capital gains income, and that's the amount that is taxed at the higher rate. A family that has $257,000 in taxable income and $80,000 in capital gains is $10,000 over the $247,000 taxable income threshold. So $70,000 of those capital gains are taxed at 15%, and the remaining $10,000 are taxed at 20%.

The treatment of dividends is similar. The Bush tax cuts created a new category of dividends referred to as "qualified"—so named because they qualify to be taxed as if they were capital gains rather than ordinary income. In order to qualify, a dividend needs to be paid by a U.S. corporation and the stock needs to have been held for at least 60 days. Roughly three-quarters of dividend income is qualified.[2] President Obama proposes to let qualified dividends revert to being taxed at the ordinary rates but only for taxpayers earning over the threshold. Thus, qualified dividends are taxed at capital gains rates until the taxpayer's taxable income exceeds the threshold, at which time they are taxed at ordinary rates. The exact amount that is taxed at the higher rate is, as with capital gains, the lesser of the taxpayer's taxable income over the threshold and his or her qualified dividend income.

One other change made by the Bush tax cuts was the gradual phase out of two provisions aimed at limiting the benefit of tax deductions for high income taxpayers. These are known as PEP, the Personal Exemption Phaseout, and Pease, named for Representative Don Pease, who proposed it.[3] These provisions came with their own income thresholds because they were also targeted at upper-income taxpayers: if PEP were reinstated next year with no changes, it would affect single taxpayers with an AGI over $178,150 and married filers with an AGI over $267,200. President Obama therefore proposes to bring back Pease but to raise the threshold for single filers to $213,600 so as not to violate his pledge (again, that is $200,000 in 2009 dollars). He would also leave the married threshold where it is (being ever so slightly above his magic number of $267,000). PEP, too, is similar: if reinstated next year with no changes it would apply to filers with incomes over $178,150 regardless of filing status, so the president's proposal would bring it back but raise the applicable thresholds to $213,600 for single filers and $267,000 for married filers.

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[2] Internal Revenue Service, IRS SOI Tax Stats – Individual Statistical Tables by Size of Adjusted Gross Income, Table 1.4, http://www.irs.gov/pub/irs-soi/09in14ar.xls.

[3] For more on PEP and Pease and how they work, *see PEP and Pease: Repealed for 2010 but Preparing a Comeback*, TAX FOUNDATION SPECIAL REPORT NO. 178 (Apr. 29, 2010), http://taxfoundation.org/article/pep-and-pease-repealed-2010-preparing-comeback.