OBBBA and the Implicit Marginal Tax Rate

Take-Away: The phaseout provisions of the One Big Beautiful Bill Act (OBBBA) could lead to implicitly higher marginal income tax rates.

Background: Much of the recent attention to the OBBBA has been related to making *permanent* the federal income tax rates, the additional of new income tax deductions, and the phaseout ranges imposed on many of the new income tax deductions. For example, the State and Local Tax (SALT) deduction was quadrupled from $10,000 to $40,000 for those individuals who itemize their income tax deductions (for years 2025 through 2029, with a 1% increase each year.) However, for those individuals whose yearly adjusted gross income (AGI) exceeds $500,000, the benefit of the SALT deduction is phased out for those in the 35%- and 37%-income tax brackets. With that phaseout, a high earning individual's actual marginal income tax rate can increase to almost 46%.

Phasedown's Impact: The OBBBA imposes a 'phasedown' [that is what it is called in the Act] on the new additional SALT tax deduction that is based on an individual's reported income, from $40,000 down to the base of a $10,000 SALT tax deduction. For an individual with modified adjusted gross income (MAGI) above $500,000, the additional SALT deduction phases out at 30% of every dollar reported over that threshold and it completely phases out at $600,000 of MAGI. At that point, the individual is left with the basic $10,000 SALT deduction (which is not part of the 'phasedown.')

Implicit Tax Rate: Because the 'phasedown' takes away potential deductions from an individual's taxable income, the 'phasedown' actually increases the individual's true marginal income tax rate to 45.5% when his/her income is $525,000. For a married couple who file jointly this true marginal income tax bracket is 41.6% with income at $525,000, and 45.5% when their reported income is at $550,000.

Note that this *implicit* marginal federal income tax bracket applies to more than just the SALT deduction and it's phaseout; it also applies to marginal income tax brackets for the phaseout of the child tax credit, taxation of Social Security benefits, when capital gains shift from being taxed at 0% to 15%, and the Qualified Business Income (QBI) deduction under IRC 199A.

Mitigating Strategies: The obvious planning objective is to keep a high earning individual's AGI below the SALT deduction's phaseout zone: $500,000 to $600,000. This can be accomplished, perhaps in part, by maximizing contributions to qualified retirement plans like 401(k) or IRAs or putting salary or bonuses income any nonqualified deferred compensation plan. At the same time, a high earning individual will want to evaluate whether to avoid triggering more reported income, like Roth IRA conversions, the exercise of nonqualified stock options and any asset sales.

Example: Donna's AGI goes from $500,000 to $600,000. If Donna was claiming a full $40,000 tax deduction for her SALT taxes, and she goes down to $10,000 in SALT deduction as her reported income crosses $600,000, Donna is effectively paying income taxes on not $100,000 more reported income, but on $130,000 more: the $100,000 of income that is actually earned and reported by Donna, plus the $30,000 of deductions that are lost by Donna. If state and local taxes are also added in to her reported income, Donna may end up keeping just half of the money that she earned.

Conclusion: As we know from prior experience, the Tax Code is full of hidden traps. The OBBBA has just added a few more traps, like 'non-published' marginal tax rates, triggered by its many new phaseout rules. Maybe folks should not work so hard to earn their bonuses if the result is that they are phased out of some of these helpful income tax deductions.

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