Know Your Marginal Effective Tax Rate

FINANCIAL AND ESTATE PLANNING

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It's 2012 - do you know what your marginal effective tax rate is?

Sure, you are probably familiar with the concept of your marginal tax rate - the amount of tax you pay on an additional dollar of income above a certain amount. For example, this year, the top federal bracket of 29% begins at $132,406. That means that for every dollar above this amount, you would pay an additional 29¢ in federal tax.

You may also be familiar with the concept of your average tax rate, which is typically much lower than your marginal rate. Your average tax rate is simply the amount of tax you pay divided by your total income. So, for the same individual who earns $132,406, her federal tax liability in 2012 would be just over $26,000 allowing for only the basic personal credit. This results in an average tax rate federally of about 20% - significantly below her 29% marginal rate.

But there is a third type of rate you need to begin paying more attention to and that's your marginal effective tax rate (METR).

Similar to the marginal tax rate, the METR goes a step further by comparing the amount of tax paid on an additional dollar of income, taking into account not only the statutory federal and provincial income tax bracket thresholds and rates, but also the impact of tax deductions, credits and income-tested government benefits.

A 2010 C.D. Howe Institute report, titled "Saver's Choice: Comparing the Marginal Effective Tax Burdens on RRSPs and TFSAs" shed an enormous amount of light on how complex our tax system actually is.

The study shows that METRs do not follow the typical graduated statutory rates, wherein progressively higher amounts of income result in higher rates. Instead, the study observed that METRs can swing wildly.

In fact, even though there are only four federal tax brackets (and three provincial brackets in Ontario, alone) the study revealed more than 30 effective brackets for a working Ontarian.

The C.D. Howe report showed that an Ontario resident's METR jumps all over the map, with a starting METR of zero, jumping quickly to over 100%, before plummeting to negative 18% and then increasing to just over 20% - all before this working taxpayer's income reaches $12,000!

Perhaps the most common example of the impact of high METRs is the dreaded clawback of Old Age Security (OAS) payments. For 2012, the clawback begins when income is over about $70,000, and results in the OAS being fully clawed back once income reaches approximately $113,000. The clawback of OAS alone can produce METRs of well over 50%, depending on your income and province of residence.

Failing to consider your METR in your financial planning discussions may lead to unintended consequences later on.

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