The IRS Tax Code Makes No Sense – What You Should Know About IRA Tax Deduction Phase Outs

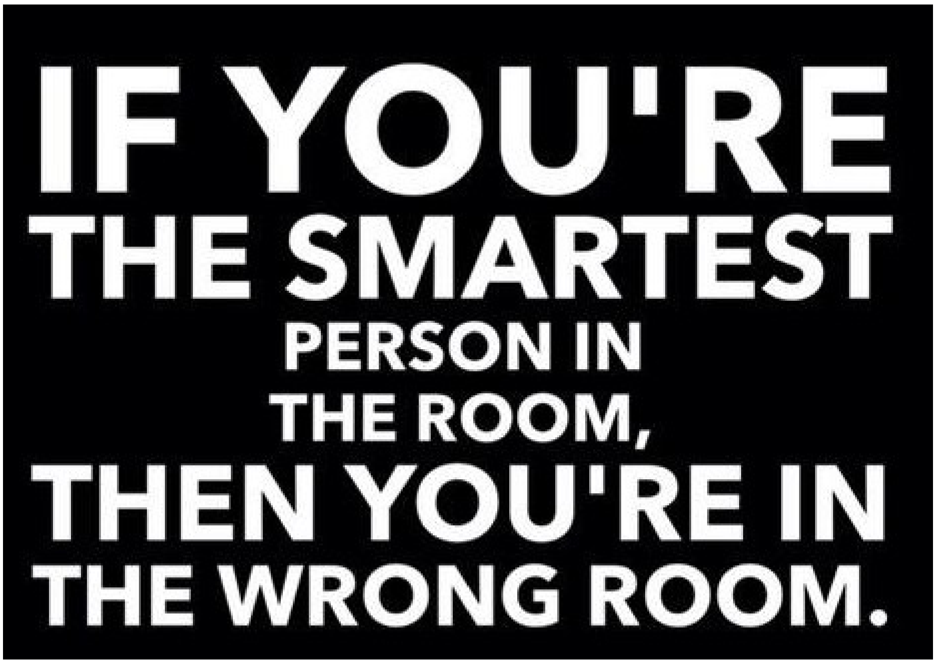
Have you ever wondered how the IRS comes up with certain pieces of tax code? It seems like every time I turn around there is some piece of tax code that makes absolutely no sense to me at all. Do they use any logic? Recently I wrote a post about joining the double comma club (i.e. becoming a millionaire) and as one of the 3 commitments I listed to max out all tax favored accounts. In my particular situation that means maxing out a 401K, HSA, and IRA for my wife.

All was good in the world…That is until the IRS gets involved.

There always seems to be some sort of penalty written into the tax code for doing well. Although this article will primarily be about how the tax code around IRA's make absolutely no sense, and what you need to know so you can make other arrangements for the "Hit" that is coming your way as you continue along your Financial Journey.

The best thing about writing a personal finance blog is that I don't make this shit up. I only write about real things experienced in my own life. You get a front row seat into a reality show that is all about the Benjamin's. My hope is that it isn't nearly as brain numbing as the reality crap that is on TV and that you can actually learn from the mistakes and victories I write about on this blog.

I will admit that I am not the smartest person in many rooms, and to be honest I prefer it that way. It leaves a lot of room for growth and learning.



Even if I'm not the smartest person in the room, I try to make sure that I am the hungriest to learn. Be a perpetual student and success is your reward. **That said, consider yourself warned that I am no tax professional and this should not be considered advice, but rather food for though**t. I am learning as I go. Trying to stay just one step ahead of the tax man *to make sure I pay the minimum amount of taxes legally possible*.

With that, let's stop the dribble drabble, and get on with the show.

The Marriage Penalty

Did you know that the tax code is actually written to penalize a married couple with two working professionals?

I know it sounds nuts. Here you are marring the love of your life and little do you know the IRS is waiting around the corner to punch you in the face. Besides what a marriage represents emotionally, it usually brings other synergies with it as well. You know the big one I am talking about, the consolidation of expenses. Instead of paying to maintain two households you now only pay for one. For many couples in my generation, including myself, we tend to move in with our future spouses before the big day and enjoy the benefits of splitting expenses.

Life is good!

We are living with the person we love and our rent just got cut in half. Our utilities just got cut in half. Let's be honest, it's way more economic to be in a relationship and live with that person than to be single living by yourself.

This is not to say that the only reason you would be in a relationship and move in together is for the financial benefit. Instead it is just an added benefit for being in love (I am smiling as I write this right now as I do a little CYA).

Time passes and you realize that you're ready to take your relationship to the next level and get hitched. Then your file your taxes jointly for the first time. That's when you realize the IRS had just sucker punched you. Why doesn't anyone warn you about the financial consequences of getting married? Do people not pay attention?

Not saying this should or would stop you from tying the knot. But it would be nice to know.

Let's take a look at the difference in filing single vs. filing a joint return.

Tax rate	Single filers	Single Filer X 2	Married filing jointly
10%	Up to $9,075	Up to $18,150	Up to $18,150
15%	$9,076 to $36,900	$18,151 to $73,800	$18,151 to $73,800
25%	$36,901 to $89,350	$73,801 to $178,700	$73,801 to $148,850
28%	$89,351 to $186,350	$178,701 to $372,700	$148,851 to $226,850
33%	$186,351 to $405,100	$372,701 to $810,200	$226,851 to $405,100
35%	$405,101 to $406,750	$810,201 to $813,500	$405,101 to $457,600
39.60%	$406,751 or more	$813,501 or more	$457,601 or more

2014 Federal Tax Brackets

In the above screen shot I wanted to provide you with the tax brackets that I used from 2014. Please note that I added in the middle column titled "Single Filer X 2" to represent what the tax bracket would be if the "Single filers" was doubled, which is not the case as you can see in the "Married filing jointly" column. I would also like to point out that we are only focusing on the federal side of taxes, but in certain states like in California where we live, there is also another hit to married couples (but that will be for another day).

Now let's take a look at what this actually means to the married couple filing their taxes.

Both earners have an AGI of $100K/year, Total AGI of $200K	
Taxes for a Single Filer	$ 21,176
Effective Federal Tax Rate	19.9%
Double Single Filer	42,352
Effective Federal Tax Rate	19.9%
Taxes for Joint Filers	43,247
Effective Federal Tax Rate	20.4%
Variance	**$ 896**

Both earners have an AGI of $200K/year, Total AGI of $400K	
Taxes for a Single Filer	$ 49,858
Effective Federal Tax Rate	24.2%
Double Single Filer	99,717
Effective Federal Tax Rate	24.2%
Taxes for Joint Filers	107,905
Effective Federal Tax Rate	26.2%
Variance	**$ 8,188**

Both earners have an AGI of $400K/year, Total AGI of $800K	
Taxes for a Single Filer	$115,858
Effective Federal Tax Rate	28.5%
Double Single Filer	231,717
Effective Federal Tax Rate	28.5%
Taxes for Joint Filers	263,553
Effective Federal Tax Rate	32.4%
Variance	**$ 31,836**

Here are the assumptions used to create these three examples:

1. Standard deduction of $6,200
2. For simplicity, assume no other deductions
3. Effective tax rates are based on gross income (AGI + standard deduction in this case)

4. AGI = Adjusted Gross Income

As you can see in the first example (Total AGI of $200K), the impact is minimal for the couple at an additional $896 in taxes owed. Since my wife and I got married, we have had an AGI of less than $200K. But looking ahead at the 2nd and third examples, you can see that the marriage tax penalty becomes much greater as a couple does better financially.

The thing that perplexes me about this whole thing is that it is more tax efficient to remain unmarried (especially if you plan to earn some serious dough). Just looking at the last example with an AGI of $800K, a married couple would save almost $32,000 a year in taxes.

Ok, so maybe most earners will never experience the 2nd and 3rd examples. Especially when you consider that the median house hold income as of 2014 for professionals age 25-34 is $54,835. However, I still think it is something to be aware of if you are a high earner that is trying to optimize your tax bill down to the least amount of taxes you can legally pay. It should also be pointed out that maybe the IRS didn't just double the tax brackets for single filers because of the following:

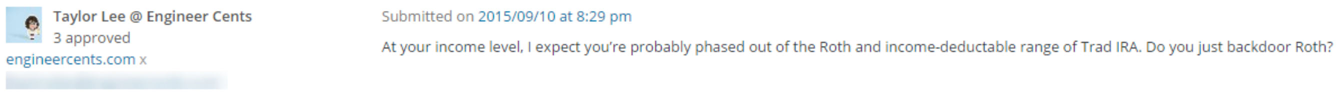
1. As a married couple you will likely have more deductions due to the likelihood of having kids.
2. As a married couple you will likely have more deductions due to the increased probability of home ownership with a potential dual income.

Whatever the reasons the IRS has decided to create the tax brackets for married couples, it doesn't really matter. These are the rules we have been given to play with and if you want to get married they are just something you have to except. At the very least know what you are really getting into from a financial perspective. Once you are aware, you can at least plan to optimize your deductions to reduce the marriage tax penalty as much as possible.

This is something I have come to accept and live with. And just when I thought that was the end of it…

The Marriage Penalty Strikes Again

As if the increase in taxes wasn't enough. Earlier in the post I mentioned a post I had recently written declaring my 3 commitments in becoming a millionaire. One of those being to max out a traditional IRA for my wife since the family business she works for does not currently offer a qualified plan like a 401K for her to contribute too. I was under the impression that if your work did NOT have a retirement plan you could contribute to, then you would get the full tax deduction for contributing up to the max $5,500 into an IRA. That was until a smart reader left the following comment:



This forced me to go to the IRS website to either prove my assumption right or wrong. I was dead wrong, according to the IRS you only get the full deduction if you have an AGI of $183,000 or less. If you look at the IRS table below you will see that it says that if you're married filing jointly and have a spouse that is covered by a plan at work then you need an AGI of $183,000 or less for the full deduction, you get a partial deduction up to $193,000, and anything above $193,000 comes with **ZERO** deduction.

WTF???

2015 IRA Deduction Limits - Effect of Modified AGI on Deduction if You Are NOT Covered by a Retirement Plan at Work

If you're not covered by a retirement plan at work, use this table to determine if your *modified AGI* affects the amount of your deduction.

If Your Filing Status Is...	And Your Modified AGI Is...	Then You Can Take...
single, **head of household**, **or qualifying widow(er)**	any amount	a full deduction up to the amount of your contribution limit.
married filing jointly or **separately** with a spouse who **is not** covered by a plan at work	any amount	a full deduction up to the amount of your contribution limit.
married filing jointly with a spouse who **is** covered by a plan at work	$183,000 or less	a full deduction up to the amount of your contribution limit.
	more than $183,000 but less than $193,000	a partial deduction.
	$193,000 or more	no deduction.
married filing separately with a spouse who **is** covered by a plan at work	less than $10,000	a partial deduction.
	$10,000 or more	no deduction.
If you file separately and did not live with your spouse at any time during the year, your IRA deduction is determined under the "Single" filing status.		

Page Last Reviewed or Updated: 06-Aug-2015

First, thank you TaylorLee, for bringing this up. Luckily after finding this out I did some quick calculations to see where I estimated our AGI to be for 2015. Because it has been an incredible income year for us, I feared that we were at risk of receiving no deduction for the contributions we had made for my wife this year. Fortunately, after doing the math we will just barely make it under the $183,000 limit after we account for all deductions.

My response to TaylorLee:

Gen Y Finance Guy
558 approved

Submitted on 2015/09/11 at 6:46 am | In reply to Taylor Lee @ Engineer Cents.

Hey Taylor Lee – I am covered at work with a 401K, but my wife is not. This year we are cutting it close with the additional income, but with our deductions we should still be able to get our AGI to $183,000 or below for 2015.

This would still allow us to take the full $5,500 deduction for my wife's traditional IRA. But we are going to run into a problem next year because based on my new compensation package, we will be phased out from this deduction which happens at an AGI greater than $193,000.

It pisses me off that the IRS rules are written this way. If we were both covered at work we would be fine, but we get penalized for making good money and having one of us not being covered with a work policy.

Here is the link to the IRS table if your interested: http://www.irs.gov/Retirement-Plans/2015-IRA-Deduction-Limits-Effect-of-Modified-AGI-on-Deduction-if-You-Are-NOT-Covered-by-a-Retirement-Plan-at-Work

Cheers!

I am glad that TaylorLee left this comment because although we will get through 2015 under the limit to qualify for the deduction, 2016 is looking to be even a better income year for us, and based on our numbers we will exceed the $193,000 phase out AGI unless we figure out other deductions or a way around this.

After my first reply to TaylorLee, I then replied a second time with ideas on how to ensure we don't lose any deductions next year.

Gen Y Finance Guy
558 approved

Submitted on 2015/09/11 at 7:03 am | In reply to Gen Y Finance Guy.

We need more deductions.

Or what we really need to do is figure out how we can convince my wife's family business that she works in to get a qualified plan set up so we are not hit with this issue.

The other thing we are looking at doing to increase our deductions is to pick up a third piece of real estate. The optimal situation for us would be to find something that is cash flow positive before depreciation, but then shows a loss on paper for tax purposes.

Non real estate professionals are allowed to pass $25,000 of "paper losses" from real estate through all other forms of income. Anything over this amount will accumulate and carry over from year to year. But this is only if you have an AGI of $100,000 or less. It completely phases out at $150,000. Which means you would only be able to use any paper losses against any gains on a future sale of the property.

However, if you qualify as a real estate professional, this deduction is unlimited and has no income requirement. Luckily for us, my wife qualifies as a real estate professional.

So it is highly beneficial for us to pick up property that shows a loss on paper.

Our income is projected to go up about $50,000 next year, so a property will help, but it will not be enough to offset our increase in income to be able to benefit from a traditional IRA.

That means you just made me realize that I really need to push for a plan to get set up at my wifes office. Need to go and sweet talk my mother in law....AKA the boss lady 🙂

Thanks for the thought provoking comment.

In the comment above I mention two things that we are looking to do in 2016 in order to continue our investing efforts while at the same time trying to optimize our taxes lower. The big one is going to be setting up a qualified plan at my wife's work. Luckily her mom (the boss) has been wanting to add a plan for her employees for a while, now its just a matter of doing the due diligence and getting one in place.

A plan will not only get us around this phase out of deduction, it will also allow us to increase our current contributions from $5,500 a year to $18,000 a year.

Lastly, we are also putting an income producing property back on the table. The perfect property would be cash flow positive with nice cash on cash returns, but then show a loss on paper after you account for depreciation (non-cash expense). We are still in the early stages of due diligence and are not even sure such a property exists.

Side Note: I still don't understand why you can contribute $18,000 to a qualified 401K plan at work, but only $5,500 if you're not fortunate to work for a company that provides a qualified plan.

Conclusion

Make sure you understand how the tax laws effect your current situation **and** at least one year out to ensure you have plenty of time to make optimizations that will decrease your tax bill and mitigate phase outs when/if possible.

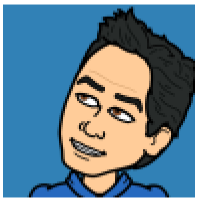
Whatever you do, don't take this back to your loved one as a way to convince them marriage is not for you because you could save a few bucks. I promise you it will not go over well, and I am mainly speaking to the male readers. The last thing you want to do is turn your marriage into a financial transaction. Seriously!!!

That would be relationship suicide.

Now it's your turn…

Were you aware of the marriage tax penalty? If so, was it ever a discussion before getting married? Also, did you realize or have you ever had to deal with the deductability of IRA contributions? What other tax issues have you had to deal with as a married couple?

-Gen Y Finance Guy



Gen Y Finance Guy

Hey, I'm Dom - the man behind the cartoon. You'll notice that I sign off as "Gen Y Finance Guy" on all my posts, due to the fact that I write this blog anonymously (at least for now). I like to think of myself as the *Chief Freedom Officer* here of my little corner of the internet. In the real world, I'm a 30-something former C-Suite executive turned entrepreneur turned capital allocator. I am trying to humanize finance by sharing my own journey to Financial Freedom. I believe in total *honesty* and *transparency*. That is why before I ever started blogging, I decided that I would share all of my own financial stats. I do this not to brag, but instead to inspire motivate, and also to hold myself accountable. My goal is to be a beacon of hope, motivation, and inspiration for *you*, the reader, by living life by example and sharing it **all** here on the blog. My sincere hope is that you will be able to learn from me - both from my successes and my failures! Read More