When can only a penny extra income cost you over $1,800 tax?

For every extra dollar of income, most people lose somewhere between nothing and $0.35 in taxes, but they still walk away with after tax income between $0.65 and $1.00. In fact, under most circumstances, $1.00 of tax-exempt income has no tax unless it is subject to the Alternative Minimum Tax (AMT), in which case the tax may vary anywhere from zero to $0.28. Part of Social Security income may be taxed so that $1.00 of extra Social Security income may lose anywhere from zero to $0.30.

All of these taxes are "graduated." That means that only those amounts of taxable income above a certain threshold are taxed at a higher rate. For 2011, the thresholds for married people were $17,000 (when the tax rate goes from 0% to 15%), $69,000 (when the tax rate goes from 15% to 25%), $139,350 (when the tax rate goes from 25% to 28%), 212,300 (when the tax rate goes from 28% to 33%) and $379,150 (when the tax rate goes from 33% to 35%).

So, for example, a couple who had $212,300 taxable income would pay $47,514 income tax. But if their taxable income was only one dollar more, their tax would be $47,514.33, an increase of only $0.33.

But there is a completely different meaning for a threshold for those over 65 and on Medicare. **Just one penny of extra income can cost well over $900 in tax for a single person—twice that for a married couple.** In the case of income tax above, tax-exempt income does not increase income tax except for the few people in very high income brackets who would mistakenly buy municipal bonds subject to the AMT, and then it's only the income from that bond that has the higher tax.

However, there are a completely different set of rules for Medicare where taxes are calculated on the basis of what is called MAGI, or modified adjusted gross income. This is the total of adjusted gross income (AGI) plus tax-exempt income. This means that deductions and exemptions don't affect MAGI, but tax-exempt income does. Also the implication of "threshold" changes because Medicare taxes are not graduated. They have abrupt increases depending on MAGI.

The Social Security Administration checks with the IRS to find your AGI and tax-exempt income from your last tax filing to get the MAGI. That sets the amount of Medicare tax that will be taken from your Social Security payments, or billed if you have not yet started Social Security. Mercilessly, a computer calculates the amount for Medicare Parts B and D. If married filing jointly, each spouse over 65 has the same tax. This can be a very large part of either spouse's Social Security, particularly the lower income spouse.

For example, a single person over 65 with a MAGI of $85,000 would pay no Medicare tax, but a person who made $85,000.01 would pay an extra annual tax of $480 for Medicare Part B and another $139 for Medicare Part D. The threshold for a married couple is higher, but the penalty is much higher. A married couple over 65 with a MAGI of $170,000 would pay no Medicare tax, but if they earned only one penny more, they would pay a tax of $960 for Medicare Part B and $278 for Medicare Part D. That's a total of $1,238 tax on only one penny of income!

The penalty per penny is even higher for higher income couples over 65. For a single penny over $214,000, the penalty is 1,877. And a penny over $320,000 adds still another $1,874. A cent above $428,000 adds still another $1,879.

So, older folks like me have to be careful when making financial decisions. A decision to sell an appreciated security or to buy a mutual fund just before an income distribution can bring painful Medicare taxes. The same thing is even more likely when converting an IRA to a Roth because that conversion adds to your other income. It's the latter situation that caused me to write this article. Maybe this reminder will help you to sharpen your pencil.

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