Financial Planning Insights

Tax Bracket Management

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Various tax planning strategies, such as Roth conversions, tax loss harvesting, and tax gain harvesting, can be effective ways to minimize taxes. However, before you implement one of these strategies, you should first understand the basics of Tax Bracket Management. Here are points to consider.

There are 12 tax brackets, not 7.

For ordinary income there are 8 brackets going from 0% (one extra bracket, due to the standard deduction) to 37%. There are also 4 tax brackets for long-term capital gains going from 0% to 23.8% (20% plus the 3.8% net investment income tax). It's important to note, the tax rate used to calculate taxes for long-term gains starts where the last dollar of ordinary income ends. Table 1 below shows how each dollar of income is taxed in 2020.

For example, Jane is single and has taxable income of $70,000. Her first $9,875 is taxed at 10%. The next dollar up to $40,125 is taxed at 12%, then the next dollar up to $70,000 is taxed at 22%. If she had $1,000 of capital gains on assets held for more than a year, the entire $1,000 would be taxed at the 15% long-term capital gains tax rate.

Tax Bracket Management can minimize taxes over the long run.

Tax Bracket Management can be used to take advantage of a lower tax rate today versus waiting to pay taxes at a potentially higher tax rate in the future. For this strategy to work, first estimate your current year income to help determine your likely tax bracket. Then this information can be used to target the appropriate strategies (see Table 2) that could provide the greatest tax benefit.

Note: If your tax situation hasn't changed from last year, your most recent tax returns could be a good place to start to pin down your income and deductions.

Here's an example of how Tax Bracket Management works.

John and Sarah are married. They have $66,000 of taxable income in 2020 ($90,800 of ordinary income minus $24,800 for the standard deduction). They want to eventually sell stock that has $50,000 of long-term capital gains (LTCG), but they're concerned about the tax impact. They can either sell it now, or over time, and they ask their planner about the tax implications. Their financial planner explains that while there could be changes in the value, they could consider recognizing those gains over a span of 4 years ($14,000 in years 1, 2 and 3; $8,000 in year 4) to stay below the 15% capital gains rate. (See Chart on page 2.)

Once you know your tax bracket, consider various tax planning strategies.

Table 2

Planning goal	Tool to use	Who should consider this
Fill up a tax bracket with…	Partial Roth conversions	Those in a lower tax bracket today than what they expect to be in during retirement
	Tax gain harvesting (TGH)	Those who are currently in the 0% LTCG tax bracket, or those with capital losses that are not being utilized
Reduce taxable income by… (could result in the ability to fill up a tax bracket with a Roth conversion or TGH)	Tax loss harvesting (TLH)	Those who have recognized capital gains that have not been offset by losses (could also be done to reduce ordinary income by up to $3,000)
	Charitable giving (like bunching or giving appreciated assets)	Those who are charitably inclined and want to offset income from a Roth conversion or capital gains
	Tax-deferred retirement contributions	Those who have not fully utilized tax-deferred accounts should consider further contributions before year-end
	HSA contributions	

Source: SCFR

Note #1: Realizing additional ordinary income can be complex and have an oversized impact on total tax, if the extra ordinary income pushes a larger amount of long-term capital gains into the next higher capital gains tax rate. To truly optimize these strategies, we recommend working with a tax advisor (preferably a CPA or enrolled agent) to do tax calculations to help target the specific dollar amounts.

Note #2: Boosting taxable income can increase the percent of Social Security income taxed, if the "combined income" (equal to adjusted gross income plus nontaxable interest plus 1/2 of

Social Security benefits) is not already above $34,000 for an individual or $44,000 for a joint return in 2020. For details, use tax software or work with a tax professional.

What should you do next?

Once you know the general concept of Tax Bracket Management, you can work with your financial planner and tax advisor to explore different combinations of tax planning tools to help you either fill your current tax bracket or reduce unwanted higher tax rates.

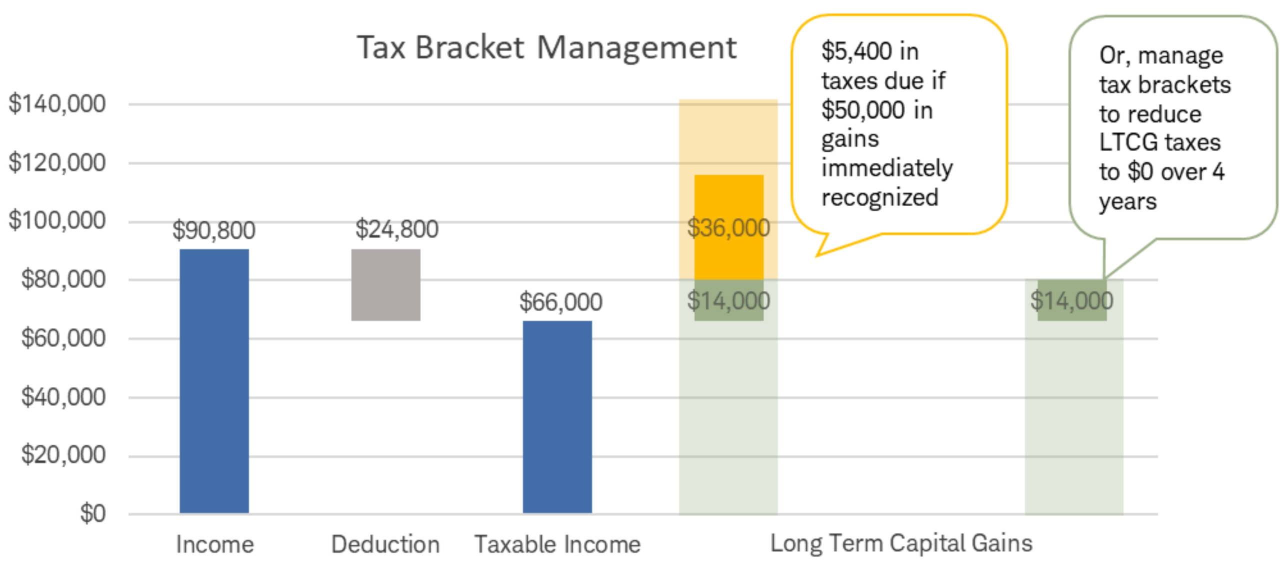
Table 1

Individual		
Income	Ordinary Income Tax	Capital Gains Tax
> $518,400	37%	20% + 3.8%*
$441,450	35%	
$207,350		15% + 3.8%*
$200,000	32%	
$163,300		15%
$85,525	24%	
$78,750	22%	
$40,125		0%
$9,875	12%	
< $9,875	10%	
Standard Deduction ($12,400)	0%	

Married Filing Jointly		
Income	Ordinary Income Tax	Capital Gains Tax
> $622,050	37%	20% + 3.8%*
$496,600	35%	
$414,700		15% + 3.8%*
$326,600	32%	
$250,000		15%
$171,050	24%	
$80,250	22%	
$78,750		0%
$19,750	12%	
< $19,750	10%	
Standard Deduction ($24,800)	0%	

Source: IRS for tax year 2020. * Net Investment Income Tax is 3.8% based on Modified Adjusted Gross Income.
Note: Ordinary income includes but is not limited to wages, net business income, retirement account distributions, Roth conversions, net short-term capital gains, and up to 85% of Social Security benefits.

Chart



Source: SCFR
Note: For illustration purposes only. The example assumes that the capital gain will remain stable over time; however, in real-life situations the capital gain may fluctuate in value, which could have future tax implications.

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Roth IRA conversions require a 5-year holding period before earnings can be withdrawn tax free and subsequent conversions will require their own 5-year holding period. In addition, earnings distributions prior to age 59 1/2 are subject to an early withdrawal penalty.

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