WEALTH MANAGEMENT INSIGHTS

Tax Bracket Management

Schwab Center for Financial Research

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Key Takeaways

- Tax bracket management is the process of "smoothing" your annual earnings in a way that can reduce your taxes over the long term.
- Often, taxpayers do not stay in the same tax bracket from year to year as annual income changes over time.
- Investors can manage their annual taxable income using a variety of tax strategies, including tax-gain and tax-loss harvesting, contributing to tax-advantaged retirement accounts, doing Roth conversions, strategic retirement distributions, or charitable giving.

Overview

Tax bracket management is a way to take advantage of a lower tax rate today, versus waiting to pay taxes at a potentially higher tax rate in the future. A collection of strategies can achieve this, such as Roth conversions, tax-loss harvesting, tax-gain harvesting, managing qualified distributions from retirement accounts, and charitable giving. Tax brackets determine how different ranges of income are taxed. Focusing on where each dollar of income falls into each tax bracket can potentially lower your taxes over your lifetime and maximize your after-tax wealth.

Who can benefit from tax bracket management?

Almost everyone can benefit from tax bracket management, no matter your current tax bracket.

How does it work?

Once you know your marginal tax rate, you may find that you can fill up that tax bracket with more income without pushing yourself into the next higher tax bracket. For example, investors who are currently in a lower tax bracket than they expect to be in the future (when they expect to make taxable withdrawals from retirement savings) can potentially benefit by filling up their current tax bracket this year by doing partial Roth conversions or tax-gain harvesting. Whereas investors in a higher tax bracket may find it beneficial to lower their current tax bill by contributing to pre-tax retirement accounts, health savings accounts (HSAs), or giving strategically to charity.

Determine your tax brackets

The first step in tax bracket management is to estimate your current-year income and identify your marginal tax brackets before year-end. Consider working with your tax professional in mid-November to do this, as you will likely have a fairly accurate sense of your total taxable income. You need to estimate taxable income for the purpose of projecting two marginal tax brackets, your ordinary income tax bracket and your long-term capital gains tax bracket.

For federal taxes, ordinary income generally includes wages and income from a business, whereas long-term capital gains generally come from investments or assets that are held for over a year and have appreciated in value over time. Investments held less than a year and sold for a gain are considered short-term capital gains and are taxed as ordinary income.

There are seven ordinary income tax brackets ranging from 10% to 37%. But not all ordinary income ends up being taxable once it's reduced by the standard or itemized deductions. Deductions could essentially create a 0% tax bracket.

Long-term capital gains have four tax brackets ranging 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. The table below shows how each dollar of income is taxed in 2024 for single and joint filers.

For a single filer in 2024, the illustration on page 3 shows how taxes are applied to taxable income across tax brackets.

- For a single filer, the first $11,600 of ordinary taxable income is taxed at the 10% rate.
- Ordinary income from $11,601 to $47,150, or the next $35,550 in additional income, falls into the 12% tax bracket.
- Taxable income dollars within each subsequent tax bracket are taxed at the respective tax bracket rate, with realized long-term gains stacked on top of the last dollar of ordinary taxable income and taxed at the respectful long-term capital gains tax rate (not shown).

Managing taxable income

Managing taxable income around tax bracket thresholds can potentially save on taxes either now or in the future.

If your income is just above a tax bracket threshold, reducing your taxable income can reduce your exposure to higher tax brackets, reducing your current tax bill. For example, you may also be able to take additional deductions or make tax-deferred retirement contributions to pull yourself down into a lower tax bracket. In the illustration on page 3, taxable income just above $100,525 or the starting threshold for the 24% tax bracket, is taxed at 24%; reducing income below this threshold eliminates income subject to the 24% rate.

Meanwhile, if your income is just below a tax bracket threshold, and you expect your income to rise in the future, increasing your income now to fill your current tax bracket could mean less future income is exposed to higher tax brackets, potentially reducing your taxes over the long term. If you're in the unique situation of being able to realize capital gains at the 0% tax rate, filling up your current tax bracket with more income without pushing yourself into the next higher tax bracket can also reduce your tax bill over the long term.

2024 Federal Tax Rates and Brackets for Ordinary Income and Long-Term Capital Gains

<table>
<tr><th colspan="3">Single Filer for 2024</th></tr>
<tr><th>Taxable Income</th><th>Ordinary Income Tax Rates</th><th>Long-Term Capital Gains Tax Rates</th></tr>
<tr><td>$609,351 and up</td><td>37%</td><td rowspan="2">23.8%
(20% + 3.8%*)</td></tr>
<tr><td>$518,901 to $609,350</td><td rowspan="2">35%</td></tr>
<tr><td>$243,726 to $518,900</td><td rowspan="2">18.8%
(15% + 3.8%*)</td></tr>
<tr><td>$200,001 to $243,725</td><td rowspan="2">32%</td></tr>
<tr><td>$191,951 to $200,000</td><td rowspan="4">15%</td></tr>
<tr><td>$100,526 to $191,950</td><td>24%</td></tr>
<tr><td>$47,151 to $100,525</td><td>22%</td></tr>
<tr><td>$47,026 to $47,150</td><td rowspan="2">12%</td></tr>
<tr><td>$11,601 to $47,025</td><td rowspan="2">0%</td></tr>
<tr><td>$0 to $11,600</td><td>10%</td></tr>
<tr><td>First $14,600 of income is covered by the Standard Deduction</td><td colspan="2">0%</td></tr>
</table>

<table>
<tr><th colspan="3">Joint Filers for 2024</th></tr>
<tr><th>Taxable Income</th><th>Ordinary Income Tax Rates</th><th>Long-Term Capital Gains Tax Rates</th></tr>
<tr><td>$731,201 and up</td><td>37%</td><td rowspan="2">23.8%
(20% + 3.8%*)</td></tr>
<tr><td>$583,751 to $731,200</td><td rowspan="2">35%</td></tr>
<tr><td>$487,451 to $583,750</td><td rowspan="3">18.8%
(15% + 3.8%*)</td></tr>
<tr><td>$383,901 to $487,450</td><td>32%</td></tr>
<tr><td>$250,001 to $383,900</td><td rowspan="2">24%</td></tr>
<tr><td>$201,051 to $250,000</td><td rowspan="3">15%</td></tr>
<tr><td>$94,301 to $201,050</td><td>22%</td></tr>
<tr><td>$94,051 to $94,300</td><td rowspan="2">12%</td></tr>
<tr><td>$23,201 to $94,050</td><td rowspan="2">0%</td></tr>
<tr><td>$0 to $23,200</td><td>10%</td></tr>
<tr><td>First $29,200 of income is covered by the Standard Deduction</td><td colspan="2">0%</td></tr>
</table>

Source: IRS for tax year 2024. * Net investment income tax is 3.8% based on modified adjusted gross income.

You can either increase or reduce taxable income with the strategies on page 5.

Example #1: Increasing taxable income to "fill" a tax bracket

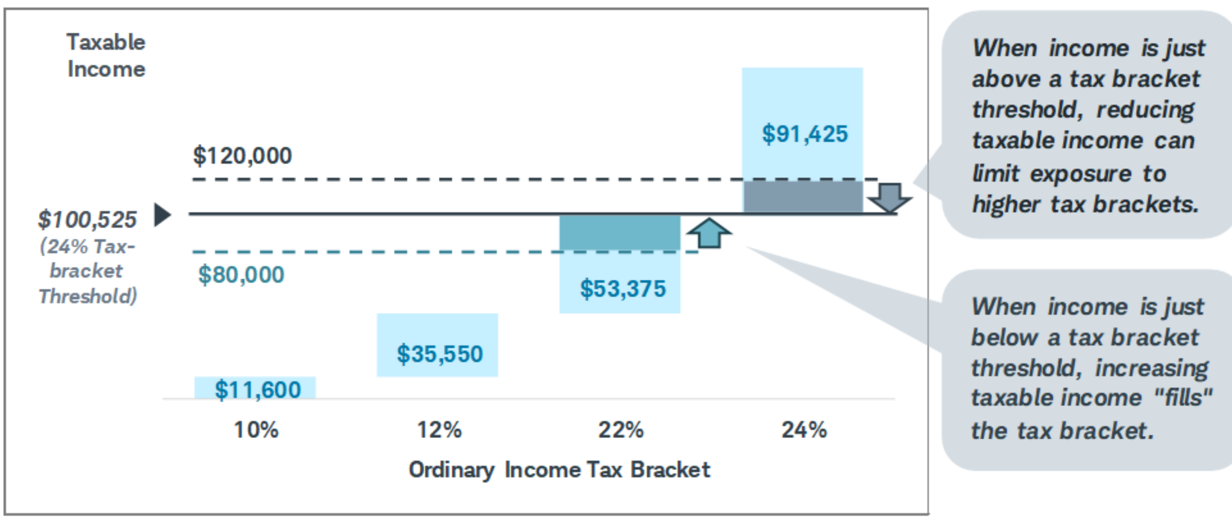
Consider John and Sarah. They are married and file jointly, with $95,000 of total ordinary income in 2024, which results in taxable income of $65,800 ($95,000 of ordinary income minus $29,200 for the standard deduction). They also have investments with significant long-term capital gains (LTCG), which they would like to sell to build their cash savings.

They recognize that their current taxable income of $65,800 puts them in the 0% LTCG tax bracket. By using the [tax-gain harvesting]() strategy, they could potential sell investments held for more than a year and realize up to $28,250 of gains without incurring any taxes ($94,050 limit for the 0% LTCGs tax bracket, less taxable income of $65,800).

Example #2: Reducing taxable income

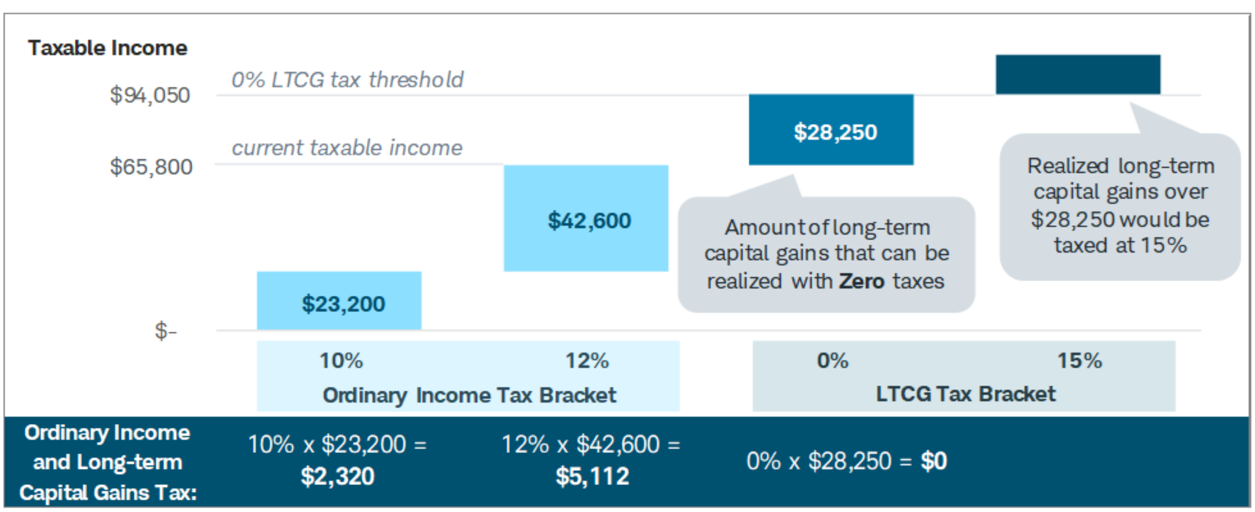
Tax bracket management can be used in the opposite direction as well, to reduce taxable income to a lower tax bracket. Consider Rick, who is on track to make $236,000 in 2024. Rick is single and plans on taking the standard deduction of $14,600. Along with his regular 8% contribution to a pre-tax 401(k) ($236,000 x 8% = $18,880), his taxable income is expected to be

Taxable Income Across Tax Brackets



Source: Schwab Center for Financial Research. For illustration purposes only. Reflective of 2024 federal tax rates for a single filer. Not all ordinary income tax brackets are shown, and the chart does not include long-term capital gains tax brackets.

John and Sarah's 2024 Taxable Income



Source: Schwab Center for Financial Research. For illustration purposes only. The hypothetical example assumes that the capital gain will remain stable over time; however, in real-life situations the capital gain may change, potentially affecting the ability to sell at a gain in the future. Reflective of 2024 federal tax rates. Realizing capital gains may impact the taxation of Social Security benefits or affect other deductions, credits, or benefits.

$202,520 for the year ($236,000 - $18,880 - $14,600), pushing $10,570 of his taxable income into the 32% ordinary income tax bracket. If he keeps his taxable income under $191,950, he can avoid the 32% income tax on income over $191,950. Rick could accomplish this by reducing his taxable income by $10,570.

Among the strategies available to reduce taxable income (increasing charitable contributions, increasing pre-tax retirement or HSA contributions, or offsetting income through capital losses), Rick decides to maximize his 401(k) contributions (limited to $23,000 per year for those under 50 in 2024), allowing him to contribute an additional $4,120. He also decides to maximize contributions to his HSA, reducing his taxable income by an additional $4,150.

Knowing that he can also use up to $3,000 in net capital losses to offset income, Rick decides to sell some taxable assets with long-term losses, locking in at least $2,300 in capital losses that can be used to offset his ordinary taxable income (known as tax-loss harvesting). The combination of the three strategies brings Rick's taxable income just under the $191,950 threshold, allowing Rick to remain in the 24% tax bracket.

Issues to consider before implementing tax bracket management

Realizing additional income can be complex, which is why we recommend working with a tax advisor (preferably a CPA or enrolled agent) to do tax calculations to help target specific dollar amounts.

Boosting taxable income can increase the percent of Social Security income that is taxed, if the "combined income" (equal to adjusted gross income plus nontaxable interest plus one-half of Social Security benefits) is not already above $34,000 for an individual or $44,000 for a joint return in 2024. For details, use tax software or work with a tax professional.

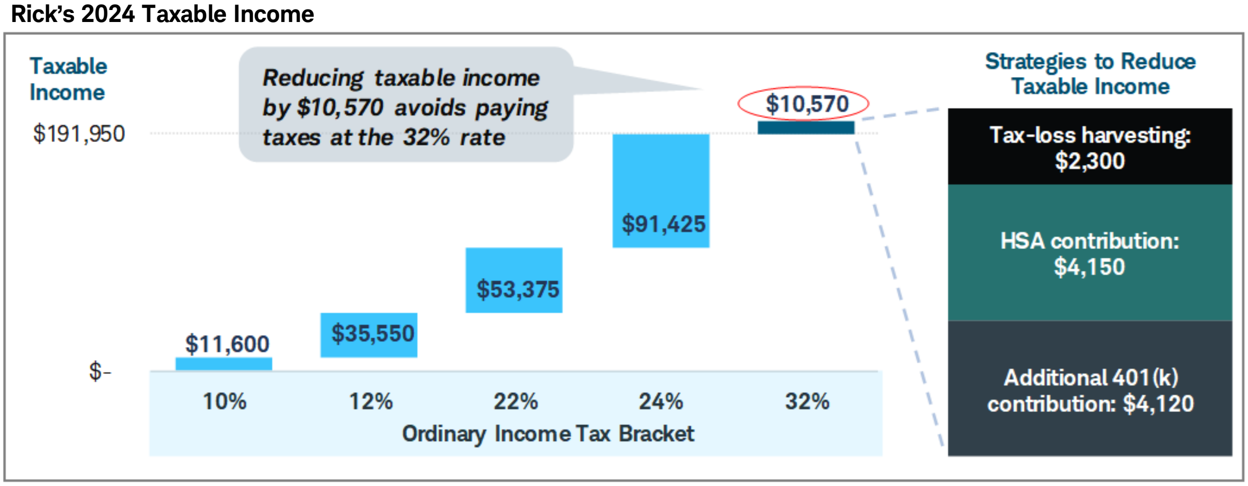
Boosting taxable income can affect certain deductions, credits, or other benefits. Realizing additional income may reduce certain tax deductions or credits. In addition, an increase in income could result in higher Medicare premiums. Consider working with a tax expert in addition to a wealth manager to help ensure you understand the potential tax implications of any additional income you realize.

The last few months of the year can be a good time for tax bracket management strategies. Although tax bracket management can be done year-round, you'll have a better idea of what your annual taxable income will be near the end of the year. Be sure to allow enough time to put any tax management strategies to work before year-end, such as making additional pre-tax retirement contributions or managing investments.

Bottom line

Effective financial planning and wealth management goes beyond investment management to strategies investors can use to increase after-tax wealth. Work with a wealth advisor in cooperation with a tax expert to explore different combinations of tax planning techniques to project, and then either fill or reduce, your current tax bracket to smooth and manage taxes over time.

Rick's 2024 Taxable Income



Source: Schwab Center for Financial Research. For illustration purposes only. Reflective of 2024 federal tax rates.

Marginal Tax Rate

The U.S. tax system is based on a progressive income tax structure that includes seven ordinary income rate brackets (and parallel long-term capital gain tax rate brackets) that increase corresponding to a range of income. Each tax bracket determines how different levels of income are taxed. The tax rate that your last dollar is taxed is called your marginal tax rate.

Tax Bracket Management Strategies

Planning goal	Tool to use		Who should consider this strategy?
Increase taxable income to fill up a tax bracket	**Manage Withdrawals**	**Roth Conversions**	*Those in a lower tax bracket today than what they expect to be in during retirement.*
		Qualified Distributions	*Those in retirement but not yet subject to required minimum distributions (RMDs) who may otherwise want to avoid a Roth conversion, including those who may need the assets within 5 years.*
	Manage Investments	**Tax-Gain Harvesting**	*Those who are currently in the 0% LTCG tax bracket, or those with capital losses that are not being utilized.*
Reduce taxable income to avoid or limit exposure to higher tax brackets	**Increase Savings**	**Tax-Deferred Retirement Contributions**	*Those who have not fully utilized tax-deferred accounts should consider further contributions to maximize the tax benefits of these accounts and reduce their taxable income.*
		HSA Contributions	
	Increase Charitable Contributions	**Charitable Giving**	*Those who are charitably inclined and want to offset income from a Roth conversion or capital gains.*
	Manage Investments	**Tax-Loss Harvesting**	*Those who have recognized net capital gains can sell investments with losses to reduce their capital gains tax. If the investor doesn't have realized capital gains, harvesting losses could be used to reduce ordinary income by up to $3,000.*

Source: Schwab Center for Financial Research

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