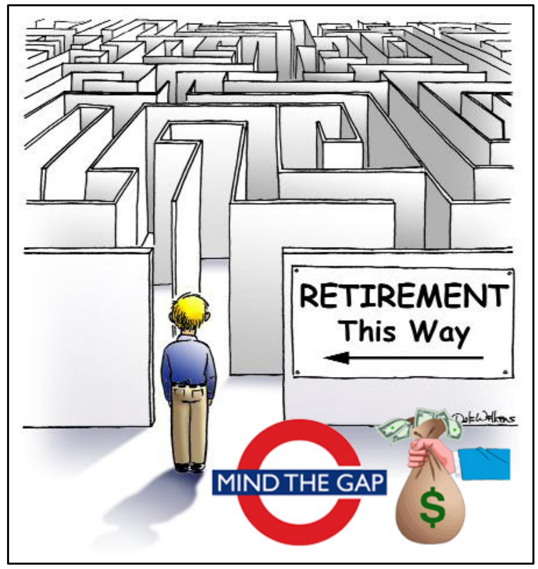
Mind the gap… and reduce your taxes

Navigating the Retirement Maze



"The art of taxation consists in so plucking the goose as to obtain the largest amount of feathers with the least amount of hissing."

– *Jean-Baptiste Colbert, French Minister of Finance (1619 - 1683)*

Clients often want to know what my expectations are for portfolio gains the coming year. I tell them that with my Ouija Board out for repairs, I can't predict the markets. Beyond adhering to best practices for portfolio construction, there isn't anything that I can do to guarantee stock market returns.

However, what I can predict is the savings that they could realize using smart tax practices: from proper portfolio asset location, to utilizing their tax return information for investment decisions and other tax reduction strategies. "I can't promise you specific portfolio returns, but I can most likely save you $4,000 on your taxes" usually gets their attention. In this article, I discuss ways to use the various income tax marginal rate thresholds together with specific tax decisions to potentially save you thousands of dollars each year.

Know your tax brackets

Not everyone is familiar with the various tax rate "brackets," in which net income after deductions is taxed at different rates. For example, a couple who is filing in 2019 as Married Filing Jointly has their first $19,050 of income taxed at 10 percent. From that level up to $77,040, incremental income is taxed at 12 percent. Between $77,040 and $165,000, the rate is 22 percent. The next band is 24 percent, which extends to $315,000. From there, rates jump to 32, 35, and 37 percent, the latter for income above $600,000.

Why are tax brackets and your income level important? It's because for each additional dollar that you earn above your base income level, you pay taxes at that rate, often referred to as your "marginal tax rate." That rate combined with the dollar difference between your base income and the next marginal tax rate level – what I refer to as the "gap" – can help you make prudent decisions that reduce your taxes. For example, let's say this year you are projecting net income after deductions of $67,000, and have an opportunity for additional earned income of $20,000. Half of that additional income would be taxed at 12 percent, and the other half at 22 percent. Thus, it may make sense to defer half of that income into 2020 by splitting your payments for that work between this year and next, saving you $1,000 in taxes if your year to year base income level remains the same. Knowing the "gap" between your current income level and the next tax rate level can be a useful tool in tactical tax reduction.

AGI vs. MAGI

Your adjusted gross income (AGI) and modified adjusted gross income (MAGI) are important figures, as they determine your ability to take certain tax credits or exemptions on your tax return. AGI is your total income minus certain adjustments. It is the figure that used to be located at the bottom of the first page of Form 1040, though now it takes a search and rescue team to find it. (Hint: See Line 7.) MAGI is the AGI with some additional deductions, and unfortunately must be calculated, as it isn't explicitly found on your return. However, most tax software and accountants can provide you with that figure.

AGI and MAGI can limit your ability to make Roth IRA contributions, take the American Opportunity Tax Credit, and various other tax credits. They also determine the amount that you can take in itemized deductions such as medical and charitable. There are ways which careful income planning can reduce your AGI and MAGI, and thus qualify for many of these credits and deductions. It may take some work, but the payoff can be large.

NIIT-picking: surtax on unearned income

The Net Investment Income Tax, or NIIT, trips up many taxpayers. For singles, it kicks in above $200,000 in MAGI, and at $250,000 for joint filers. It is a 3.8 percent additional tax imposed on unearned income above those levels. Unearned income includes dividends, interest, capital gains, and net investment rental income.

Depending upon your anticipated income for the year, the gap between that and the NIIT tax might be a deciding factor on how much to take in capital gains this year or next. (Note: Don't let tax decisions be the sole determinant of your investment decisions. An additional 3.8 percent might pale in comparison to a potential 30 percent loss if by delaying taking gains you put your investment at risk.)

Medicare surtax: Blame it on IRMAA

This is the tax that hits many Medicare recipients by surprise, partly because it occurs two years after their income exceeds certain thresholds. IRMAA is a surtax applied to Medicare Part B and D premiums for one year. In 2019, if joint filers have above $170,000 in MAGI, they will be charged an additional $1,298 for Medicare Part B and $298 for Part D in 2021. If MAGI exceeds $214,000, Medicare costs two years hence will increase by $3,250 and $766, respectively. There are four additional Medicare MAGI thresholds, each with an increased surcharge. As it only affects those age 65 or above, there are some financial moves that can retirees can make – Roth conversions and Qualified Charitable Distributions are two of them – that can mitigate the impact of IRMMA.

Capital Gains tax: How about 0 percent?

Most taxpayers assume that if they hold investments longer than a year, they pay a reduced Federal tax rate of 15 percent of the long-term capital gain (LTCG). (Note: Collectibles and precious metals are an exception, as they are taxed at a standard LTCG rate of 28 percent.) However, for couples with income below $78,750, LTCG up to that level are not taxed. For example, if you expect to have joint income of $50,000 in 2019, you can fill that income gap with up to $28,750 of LTCG tax-free. The threshold for single filers is half of that figure: $39,375.

Check your gaps annually

Your income is not static, and neither are tax laws. Do a check-up of your estimated AGI/MAGI each year around this time and again towards the end of the year. Then work with your financial advisor to determine which gaps you can fill and which thresholds you want to avoid, and plan your tax-saving moves accordingly. The tax dollars that you avoid are as tangible as those from portfolio gains, and a lot less speculative.

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