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WEALTH MANAGEMENT

Four Strategies to Lower Taxable Income Under New Tax Brackets

Many more people (and to a much greater degree) now stand to be winners or losers than under the old tax law, says WSJ Wealth Expert Jonathan Guyton. **PHOTO:** GETTY IMAGES/ISTOCKPHOTO

By

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Our income tax code now has seven rates/brackets ranging from 10% to 37%–compared with the seven rates/brackets ranging from 10% to 39.6% we had through 2017.

But if you think nothing much has changed, you haven't looked closely enough.

Many more people (and to a much greater degree) now stand to be winners or losers than under the old tax law.

Here's why. The old bracket structure had one big rate jump–from 15% to 25%. Any taxable income over the 15% threshold immediately increased to a 67% higher rate. Beyond that, came four further bumps, all much smaller, with rates rising from 25% to 39.6%. Now, we have two significant increases: an 83% jump from 12% to 22% and, later, a 33% jump from 24% to 32%. No other rate step from one bracket to the next is anywhere near as big.

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At its core, savvy income tax planning is about knowing when–and when not–to pay taxes that will eventually come due. The key is about timing and tax rates. When it comes to tax planning, it isn't what you make, it's what you get to keep. Even the most sophisticated issues can be reduced to three basic decision-making rules: 1) paying less overall is better than paying more overall; 2) paying later is usually better than paying sooner; and 3) sometimes, however, paying sooner can bring significant payoffs.

So, what do these bracket jumps mean and to whom do they matter? Four situations, encompassing millions of taxpayers, come to mind. Here are some basic and more advanced strategies to consider.

1. Retiree income. Retirees in their 60s have great tax-planning flexibility, but only until age 70 1/2. That's when most higher-earning spouses and healthy singles are smart to claim their Social Security benefits, and when fully taxable required minimum distributions (RMDs) from 401(k)s and IRAs begin. After that, future tax bills are fairly "baked-in" and, for many retirees, there are few ways to keep some of this income out of the 22% bracket. Instead, why not pay taxes on some retirement savings at 12% in prior years by converting them to a Roth IRA? This basic, but powerful, technique can lower the tax burden on thousands of tax-deferred dollars with some proactive annual tax planning.

As an advanced approach to create even more room for low bracket conversions, they can pair them with deductible lump-sum deposits to a donor-advised fund (DAF) to cover their giving until age 70. After that, they can give to their favorite charities via qualified charitable distributions from their IRA to lower the amount of your RMD that's taxable since this can also decrease the taxable portion of Social Security.

2. Future single taxpayer. A unique tax challenge is faced by married couples where one spouse has a chance of being a survivor for a number of years: becoming a single taxpayer, where the 22+% brackets start twice as soon even though the survivor's income doesn't decrease by nearly that much. It's the cruelest tax increase in the law. Widow(er)s over age 70 have nearly no defense. Being proactive is key.

As a basic strategy, they should do Roth conversions to "fill up" the 12% tax bracket ($38,700 of taxable income for singles, $77,400 for those married filing jointly) to lower future RMD amounts likely to be taxed at 22%.

For a more advanced approach, they should implement your desired portfolio allocation by investing those Roth assets heavily in equities (stocks or stock ETFs/funds) to grow tax-free so that remaining IRA and 401(k) assets can be more heavily invested in bonds (fixed income) to lower the amount of future RMDs.

3. Small-business owners. Most small-business owners (and farmers) have fluctuating incomes from year to year. Sometimes there are years with very low income. They can use these low-profit or loss years to "fill up" the low 12% bracket with conversions from their traditional IRA, or 401(k) if they have one, to a Roth IRA or 401(k) for future tax-free growth.

As a more advanced approach in high-profit years, they can treat more of their profit as W-2 salary (rather than as K-1 income) in order to take full advantage of the maximum $55,000 ($61,000 if you are age 50+) pretax deposit allowed into a profit-sharing plan. Such tax-deferred plans can offer the greatest benefit for keeping taxable income below $157,500/$315,000 and at a 24% tax rate, rather than jumping to 32% above that.

4. Company-stock holders. Executives and other employees with significant holdings in their companies via stock options or restricted stock units (RSUs) face unique planning challenges. The gains in these options are deferred until exercised or sold; then they are taxed as ordinary income at the same rates and brackets as above. A helpful basic strategy is often to spread the taxation timing across two tax years if it can avoid one of these big bracket jumps. Remember that December and January are separated by both a month and a tax year.

As a more advanced strategy, they can lower this high-bracket taxable income by putting several years' worth of charitable contributions into a DAF to maximize the tax savings from their generosity.

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