Making the most of your tax bracket opportunity

Why should you care about tax bracket opportunities? Because not knowing how tax brackets work could mean missing out on opportunities to help make the most of your tax situation and—potentially—pay less in taxes.

The U.S. uses a progressive tax system that divides your taxable income into ranges called tax brackets. Each range of income gets taxed at a certain rate, and you pay that rate only on the amount of your income that falls into that range.

Knowing which tax bracket each dollar of your income falls into can give you the potential for tax savings not just today, but in the future as well. In addition, there are two general rules to keep in mind:

> **Rule No. 1:** If you expect to make less income and be in a lower income tax bracket this year than next year, you may want to take more income this year and defer deductions to next year.
>
> **Rule No. 2:** If you expect to make more income and be in a higher income tax bracket this year than next year, you may want to defer income to next year and take more deductions this year.

In other words, understanding how tax brackets work, along with keeping in mind these two general rules, may help you make better decisions when it comes to your finances.

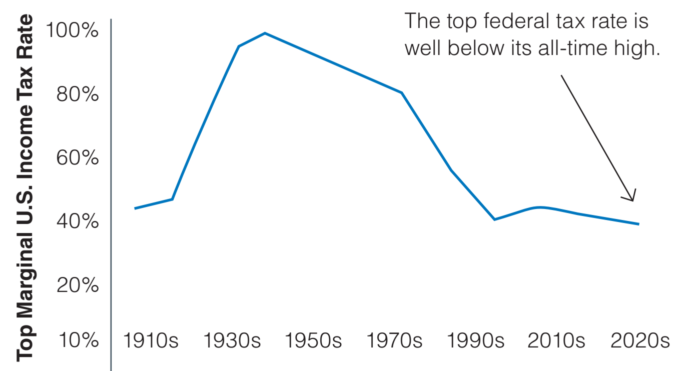
How do tax brackets work?

Our current federal income tax system has seven tax brackets with these tax rates: 10%, 12%, 22%, 24%, 32%, 35% and 37%.

A common misconception is that falling into a certain tax bracket means you'll pay taxes at that rate on all your income. The truth is that this is a *marginal* income tax rate, meaning that it's the rate at which the *next* dollar of income is taxed. Only those dollars that fall above the tax bracket minimum are taxed at that rate. So, you end up paying taxes at progressively higher rates as your income moves from one bracket to the next.

A brief history

From 1944 to 1945, the highest federal individual marginal income tax rate was 94%. From 1988 to 1990, the top marginal ordinary income tax rate was 28%—one of the lowest in history. In 2020, the top marginal individual income tax rate falls in between, at 37%.



Source: Internal Revenue Service

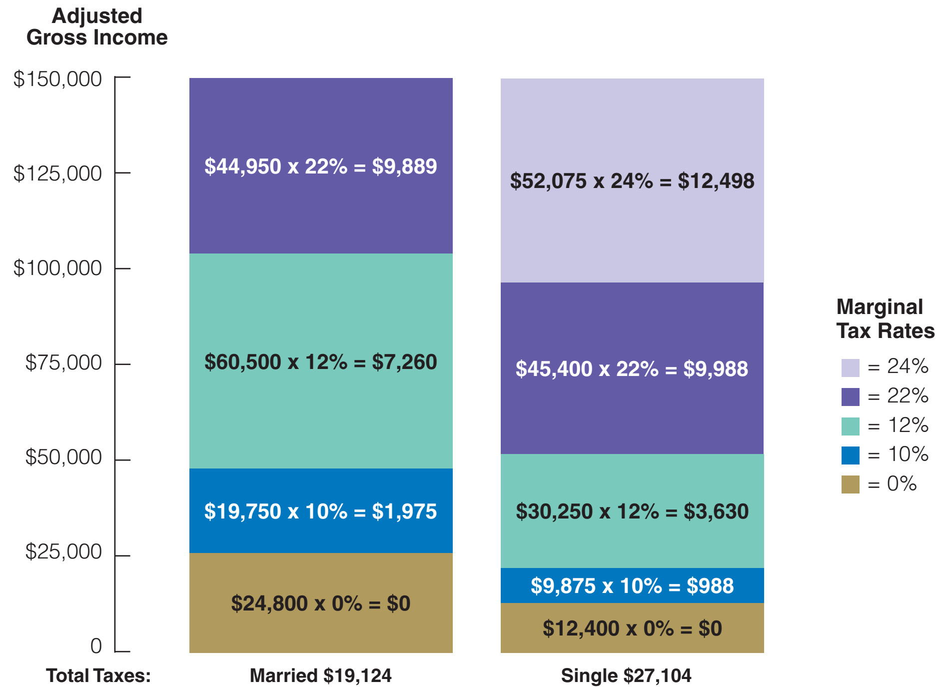
No one knows for sure where tax rates are headed. However, by working with your Thrivent financial professional and a tax professional, you can get a firm grasp on your current year's marginal income tax rate and a good idea of what next year's will be, which may help you make more informed financial decisions.

The potential impact of joint versus single tax filing

One of the main factors in the amount of tax you pay is whether you're filing a joint tax return or a single tax return. This chart illustrates the difference in taxes based on the 2020 federal marginal ordinary income tax rates for married taxpayers and single taxpayers.

The chart assumes the taxpayers are taking a standard deduction;* this amount is reflected in gold at the bottom of each column. The figures inside each section of the column, moving from the bottom to the top, are the amount of taxable income subject to each marginal rate.

Window of Opportunity



The chart does not reflect adjustments imposed on individuals with higher incomes, such as tax breaks and deductions that are reduced or eliminated as income exceeds certain thresholds. State income taxes, if applicable in your state of residence, are not reflected in this chart.

How to read the chart

Assume a married couple or a single individual earned $150,000 in 2020. Here's how they might be taxed:

Joint filer

	Income	Marginal tax rate	Taxes owed
First	$24,800*	0%	$0
Next	$19,750	10%	$1,975
Next	$60,500	12%	$7,260
Next	$44,950	22%	$9,889
Totals	**$150,000**		**$19,124**

Single filer

	Income	Marginal tax rate	Taxes owed
First	$12,400*	0%	$0
Next	$9,875	10%	$988
Next	$30,250	12%	$3,630
Next	$45,400	22%	$9,988
Next	$52,075	24%	$12,498
Totals	**$150,000**		**$27,104**

*Standard deduction of $12,400 for single filer and $24,800 for joint filers.
Additional deduction for age 65 or over or blind: Married = $1,300; Single = $1,650.

Case No. 1: Taking more (or less) income this year

Although we often don't have a choice, sometimes it makes sense to put off receiving income that's taxable. Consider Carl and Kathy. They're both in their late 60s and retired. They've been talking to their Thrivent financial professional and accountant about taking $5,000 from one of their IRAs as a taxable distribution. Even though they don't need the money right now, they're hoping to reduce the amount of taxes they'll owe when they begin taking required minimum distributions (RMDs) in the future.

This year Carl and Kathy are in the 22% marginal income tax bracket. Next year their accountant tells them they'll probably be in a 12% marginal bracket. If Carl and Kathy wait until next year to take the IRA distribution, they could save $500 in federal income taxes ($5,000 x 10%).

Case No. 2: Using an IRA to save on taxes

Mary is a single taxpayer in her early 30s who is in a 22% marginal income tax bracket. Although it's a long ways off, she wants to start saving more for her retirement. So she's thinking about opening a traditional IRA this year and making a $6,000 tax-deductible contribution.

After consulting with her Thrivent financial professional and her tax advisor, Mary learns that contributing to the IRA would not only put her on the road to a more comfortable retirement. In the first year alone, it would also potentially save her $1,320 in income taxes ($6,000 x 22%).

Case No. 3: Planning for the worst; hoping for the best

Bill and Judy are in their 50s, currently file a joint federal income tax return, and have an adjusted gross income of $150,000. This puts them in a marginal income tax bracket of 22%. Although Bill has retired, Judy continues to work at a job she loves.

But what if the unthinkable had happened and Bill had died last year? Judy would still have been able to file a joint tax return in the year Bill died. But this year, even though her income hasn't changed, her tax filing status will. Using the Window of Opportunity chart on page 2, Judy's marginal income tax rate as a single taxpayer increases to the 24% bracket this year, resulting in her anticipated income tax bill increasing by $7,980.

Fortunately, by working with their Thrivent financial professional and planning for this possibility ahead of time, Bill and Judy can put their affairs in order. They can account for Judy's reduced income after Bill's death and address the potential changes in her federal income taxes so she won't be caught unprepared.

These hypothetical examples are for illustrative purposes only. They are not intended to represent the performance of any particular investment product, nor do they take into consideration any product expenses, fees or sales charges. The results would be reduced if these expenses were included.

Your effective tax rate: the rest of the story

As the examples on the previous page show, being aware of which marginal tax bracket your current income falls into is vital for short-term decision making. In addition, it can help you make decisions with financial clarity that may benefit you in the next year or two.

Understanding how effective tax rates work can also help you prepare for the long term. For example, if you know how to calculate effective rates, you can get a better estimate of the gross (taxable) income you'll need in retirement to be able to have the lifestyle you want.

So what is the effective tax rate? Simply put, it is the average rate at which all of your taxable income is taxed. Just divide your total taxes by your taxable income and that's your effective tax rate.

Comparing marginal versus effective tax rates

Using the Window of Opportunity chart on page 2, you can calculate the effective tax rate for a married couple filing jointly or a single individual as follows.

	Joint filer	Single filer
Adjusted gross income (AGI)	$150,000	
Marginal tax bracket	22%	24%
Total taxes	$19,124	$27,104
Effective income tax rate (Total taxes/AGI)	12%	18%

Another way to look at this is that your **marginal tax rate** is what you'll pay on the next additional dollar of taxable income, while the **effective tax rate** is what you've paid on all of the previous taxable dollars. Knowing this can help you plan for situations in which changes to either your taxable income or your tax-deductible expenses can move you from one income tax bracket to another.

Let's get you where you want to go—today

Your Thrivent financial professional can help you understand your options and guide you to a decision that meets your needs and goals.

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