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Fundamentals of tax planning: Going beyond the basics

Within financial planning, tax planning is traditionally viewed in the context of how a financial plan should be implemented.[1] But tax planning can also be a starting point to determine what financial planning techniques may be appropriate for an investor's portfolio. By understanding the mechanics of an investor's Form 1040, it may be possible to reduce taxable income using common financial planning techniques. The money saved in taxes is tangible and can be put to immediate use by the investor.

This paper highlights common tax-saving opportunities. While each investor's tax situation is unique, there are four key areas to focus on:

Threshold planning

In a progressive tax system, tax rates increase with income. Accelerating or deferring income to remain in a targeted tax bracket can be a powerful tool for managing an investor's tax liability.

Capital gains

Capital gains taxes not only will reduce an investor's net return but may also create a tax liability. Proper management of capital gains and losses can affect both net return and total tax liability.

Income exclusions

While most income is subject to income tax, some types of income are specifically excluded. Taking advantage of opportunities to shift from included to excluded sources of income can reduce taxable income on a dollar-for-dollar basis.

Deductions

With the recent increase in the standard deduction, many investors may not be fully benefiting from their tax deductions. Being strategic about timing can help investors get the most out of them.

"Tax planning is when a taxpayer makes use of the tax law to pay the least amount of taxes possible. ...Unlike tax evasion and fraud, tax planning is not unlawful."[2]

1 This paper is based on the 2023 tax code. All references in the paper to tax are specific to federal income tax unless otherwise noted.

2 *Tax Planning* (Cornell Law School Legal Information Institute, 2022); available at www.law.cornell.edu/wex/tax_planning#.

Threshold planning

Fundamental to tax planning is the premise that each incremental dollar of income should be taxed at the lowest possible rate. A tax threshold is essentially the last dollar included in an income tax bracket. Upon earning an additional incremental dollar, the investor enters the next tax bracket. Threshold planning aims to keep investors within a target tax bracket. Depending on one's goals and expectations, it may make sense to decrease, defer, or accelerate income. Sometimes paying taxes sooner pays off for the investor later.

This is the first installment of a tax-planning framework series. It presumes the reader has a fundamental understanding of basic federal income tax calculations.

Consider, for example, the following hypothetical investors:

Marco and Lina are a married couple filing jointly with a current joint taxable income of $369,000. For the current tax year, they are in the 32% marginal tax bracket, but only barely. Just $4,800 of their income is being taxed at 32%, while the remaining $364,200 is being taxed at a top rate of 24%. Understanding this, Marco and Lina may be able to adjust their income for the next tax year to keep their taxable amount under the 24% threshold, saving $1,536 in tax.

Ravi and Nima are a married couple filing jointly with combined annual salaries of $175,000, placing them in the 22% marginal tax bracket. They want to start converting some of their traditional individual retirement account (IRA) money to Roth to plan for retirement. However, this year Nima will get a one-time work bonus of $15,000, pushing the couple to the very top of their current marginal tax bracket. Because they don't anticipate additional bonus money after this year, it may make sense for them to delay their Roth conversions to future years, when they can convert at their current 22% marginal tax rate.

Daphne is a single taxpayer with an adjusted annual gross income of $140,000. She anticipates that her income will rise significantly over the next few years and wants to take advantage of her current circumstances to do some Roth conversions. In this situation, Daphne will accelerate income up to the top of her current 24% marginal tax bracket. She can convert up to about $40,000 from her traditional IRA to a Roth this year without paying a higher tax rate.

The multistep process of evaluating an investor's current income versus future expectations informs the degree and magnitude of income adjustments to target. The question then becomes how to adjust an investor's taxable income. That is the focus of the rest of this paper.

Capital gains

Capital gains are a key component of gross income. On an investor's 1040, capital gains are shown as an aggregate amount, but it can still provide a starting point for discussions leading to greater tax efficiency.[3]

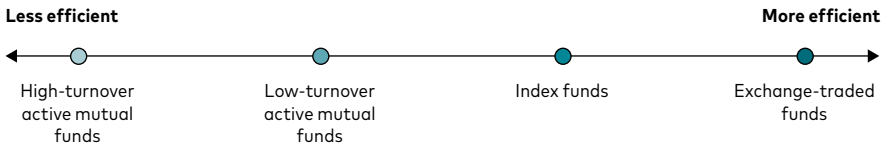
Both fund-level and individual transactions can trigger capital gains. Fund-level transactions occur when mutual fund holdings issue dividends or pay interest, or when a fund makes a trade that triggers a capital gain. An individual transaction occurs when the account holder sells an investment. Analyzing the transaction-level data in statements to understand what triggered taxable capital gains is a key starting point for determining what tax-planning strategies may be appropriate. Pay particular attention to short-term gains; they do not receive the preferential tax rates that long-term capital gains do, and steps should be taken to avoid them.

Mutual fund-level distributions

To reduce gains generated at a fund-transaction level, consider shifting the portfolio over time into more tax-efficient investments. Metrics including a fund's turnover ratio, tax-adjusted return, and potential capital gains exposure can provide insight into the fund's tax efficiency. In addition, options such as exchange-traded funds (ETFs) and index funds typically generate fewer fund-level capital gains and losses (**Figure 1**).

FIGURE 1

Investment options span the tax efficiency spectrum



Source: Vanguard.

3 IRS Form 1040, Line 7, and Schedule D.

Individual-level transactions

Capital losses. Investors are taxed only on their net capital gains for the year, meaning the gains remaining after any realized losses have been subtracted. Capital losses in excess of capital gains create capital loss carryforwards for use to offset capital gains and income in future years. When analyzing an investor's capital gains, check that capital losses were appropriately accounted for and look for carryforwards from prior years that can also be used. One way to generate capital losses is through tax-loss harvesting (TLH). While it is often seen as a year-end activity to address the investor's annual capital gains, opportunities for TLH can occur at any time, particularly during periods of market volatility.

Capital gains. For capital gains generated at the investor level, there may be options to streamline transactions to minimize tax. Capital gains are frequently generated by standard transactions such as rebalancing, repositioning a portfolio, or gifting. Rebalancing in tax-deferred accounts or gifting overweighted shares in kind can improve the tax efficiency of these transactions. Investors who rely on portfolio income can use those same standard transactions to improve the tax efficiency of their cash flow. For example, fund distributions and proceeds from rebalancing, repositioning, or TLH can be used to fund the cash account. This minimizes the need for additional transactions to generate cash. Also, when repositioning a portfolio, it's advisable to redirect fund distributions and transaction proceeds into the desired positions rather than automatically reinvest them. This same approach can be used to reduce the frequency of required rebalances by directing fund distributions into underweight positions.

And watch out for cost basis. The default cost basis treatment for a given transaction may not be optimal for the investor; other available options may be more tax-efficient. Evaluating positions at the tax-lot level, while time-consuming, may provide hidden opportunities for TLH and offers the maximum control over capital gains for the year.

Consider this example:

Jacob and Sofia are a retired married couple who file jointly. They periodically draw from their taxable retirement accounts to help fund their spending needs. Last year, they had ordinary income of $140,000 and capital gains of $22,000. Their portfolio is set up to automatically reinvest dividends and annual fund distributions, and qualified dividends and fund distributions accounted for $9,000 of those capital gains. Because the $9,000 was automatically reinvested, it was not received by or available as liquid to the couple. On top of that, Jacob and Sofia decided to take a cruise and needed to take $7,000 from their taxable accounts to fund it. After evaluating the couple's annual spending needs, their advisor adjusted their taxable accounts to have all proceeds from necessary transactions fund a cash account rather than be reinvested. The advisor also evaluated their account's default cost basis method and adjusted it to avoid selling short-term holdings. Through these adjustments, the advisor was able to save the couple almost $1,200 in taxes. **Figure 2** looks at that impact.

FIGURE 2

Evaluating automatic settings can lead to greater tax efficiency

Outcome of eliminating automatic reinvestment

	Original	Adjusted
Short-term capital gains	$4,000	$2,000
Fund distributions and rebalancing	$2,000 (reinvested)	$2,000
Cash from sale	$2,000	—
Long-term capital gains	$12,000	$7,000
Fund distributions and rebalancing	$7,000 (reinvested)	$7,000
Cash from sale	$5,000	—
Total taxable gains	$16,000	$9,000
Reinvested gains	$9,000	—
Income received	$7,000	$9,000
Tax on short-term capital gains	$880	$440
Tax on long-term capital gains	$1,800	$1,050
Total tax on capital gains	$2,680	$1,490

Notes: This illustration is hypothetical and is not representative of any client's account or the returns on any particular investment(s). The calculated tax on short-term capital gains assumes a 22% marginal tax rate. The calculated tax on long-term capital gains assumes a 15% capital gains rate.

Source: Vanguard.

Income exclusions

Gross income includes "all income, from any source … unless excluded elsewhere." The income that's "excluded elsewhere" offers the best opportunity for tax planning, but there are only a few common options, including municipal bond income and qualified distributions from a Roth IRA.[4]

Municipal bond income

Municipal bond income is specifically excluded from federal income tax. Switching out of taxable bonds and into tax-free municipals can be one way to lower the investor's tax bill. Muni bonds, though, often pay less interest than equivalent corporate bonds, so it's important to compare muni and taxable bonds on an after-tax basis.

Certain municipal bonds are included in the alternative minimum tax calculation. Investors at risk of having to pay AMT need to understand the type(s) of municipal bond(s) being employed.

William holds a taxable corporate bond that pays 3.85%. He wants to know what rate a muni bond would need to pay in order to yield an equivalent after-tax rate. For an investor in the 22% tax bracket, it would need to pay 3% to match the corporate bond's yield (**Figure 3**).

FIGURE 3
Calculating tax-equivalent yield

Corporate bond yield:	3.85%
Marginal tax rate:	22%
After-tax yield:	3.85% x (1 – 0.22) 3.85% x (0.78)
Equivalent municipal bond yield:	3.00%

Note: This illustration is hypothetical and is not representative of any client's account or the returns on any particular investment(s).
Source: Vanguard.

Interest income is reported as both taxable and nontaxable interest for the year. Understanding which holdings generated any taxable interest shown can provide insight into whether an opportunity exists to shift into a more tax-efficient option.

4 26 U.S. Code § 64–Ordinary income defined; IRS Form 1040 Lines 1–8 and Line 9.

Roth account income

Qualified distributions from Roth accounts—Roth IRAs and Roth 401(k) plans—are also excluded from taxable income. While Roth contributions will not lower taxable income in the short term, they can provide additional flexibility for threshold planning in the long term. Making Roth contributions early in one's career provides a few advantages. First, because the investor's income is generally at its lowest then, the tax on their Roth contribution is paid at their lowest tax rate. Second, starting early allows more time for the Roth assets to grow in value, increasing the investor's base of tax-free assets.

Having a variety of account types helps with managing tax thresholds in retirement. Optimizing the distribution of income can be a complex process focused on balancing withdrawals from taxable, tax-deferred, and Roth accounts to achieve the most tax-efficient combination. Understanding the investor's anticipated income and cash flow can help identify what approach makes the most sense. For example, investors with fairly consistent income may benefit from a balanced approach to distributing taxable and tax-free income. Investors with significant fluctuations in income may benefit from a more tactical approach.

Line 4 IRA distributions on a 1040 are subdivided into total distributions and taxable amount. Remember that nontaxable distributions may come from both a traditional IRA and a Roth IRA.

Reference: For more information on next-dollar allocation, see *Vanguard's guide to financial wellness.*

Deductions

Tax-deferred retirement accounts

Unlike Roth accounts, tax-deferred retirement accounts offer an immediate tax benefit. The most common options are 401(k) plans and traditional IRAs.

Contributions to both 401(k) plans and IRAs are deductible dollar for dollar, but the contributions are accounted for differently. 401(k) contributions are reported by the employer as a separate nontaxable item, not as a deduction on the investor's 1040. IRA contributions, however, are taken as a deduction on the 1040.[5] This difference may be used to increase the deductibility of IRA contributions or allow for direct Roth IRA contributions.

The deductibility of traditional IRA contributions depends on both the IRA owner's income and, for married couples filing jointly, whether either spouse has access to an employer-sponsored retirement plan.

Consider this example:

George is a single taxpayer who contributes to both his employer-sponsored 401(k) plan and an IRA. He is maximizing his 401(k) employer match but has not reached his 401(k) deferral limit for the year. With his IRA, he is making the maximum annual contribution of $6,500, but his current income of $83,000 means that he exceeds the income limit for deductible IRA contributions. By shifting a portion of his IRA contributions to his employer-sponsored 401(k), he may be able to increase the deductibility of these contributions (**Figure 4**).

FIGURE 4

Deferrals to employer plan can affect the ability to deduct IRA contributions

Effect of George's shifting some retirement savings to his 401(k)

	Original	Adjusted
Ordinary income	$83,000	$83,000
Total contribution to retirement plans	$6,500	$6,500
401(k) allocation	—	$3,000
IRA allocation	$6,500	$3,500
Deductible IRA amount	—	$1,050
Taxable income	$83,000	$78,950

Note: This illustration is hypothetical and is not representative of any client's account.
Source: Vanguard.

5 IRS Form 1040, Schedule 1.

Standard and itemized deductions

Investors have a choice between taking specific itemized deductions or a standard deduction available to all taxpayers.[6] Investors can compare their total itemized deductions for the year with the standard deduction and choose the higher figure of the two. However, planning over a multiyear time horizon can help maximize an investor's total deductions.

Maximizing charitable deductions

Generally, a charitable donation deduction is itemized and usable only when a taxpayer's total itemized deductions exceed the standard deduction. For this reason, donors who make smaller periodic gifts often lose the tax benefit of the charitable contribution. One option to maximize the deductibility of charitable donations is to bunch multiple years' worth of donations into a single year. A donor-advised fund (DAF) is a charitable entity that acts as a holding account for funds earmarked for future charitable gifts. Once the DAF is funded, periodic donations are drawn from it rather than coming directly from the investor. In years when a taxpayer makes a bunched charitable gift, the itemized deduction exceeds the standard deduction. The taxpayer then takes the standard deduction in years when no contribution is made. Nothing has been lost, but the investor has gained the additional itemized deduction.

6 IRS Form 1040, Line 12; Schedule A of the 1040 covers itemized deductions, which include such items as state and local taxes (SALT), mortgage interest, charitable gifts, and medical expenses.

Consider this example:

Idris and Amara are a married couple who file jointly. Their itemized deductions including $8,000 each of mortgage interest, state and local taxes, and charitable gifts, for an annual total of $24,000. This is just under their standard annual deduction of $27,700. Because they could take the $27,700 deduction regardless of their charitable donations, the tax benefit is essentially lost to the standard deduction. As part of a new charitable gifting strategy, the couple will now give two years' worth of donations every other year, using a DAF. In the years when their donations are bunched, they receive an additional deduction of $4,300 for year one and $3,700 for year three. In the years when they don't make contributions, they continue with a standard deduction (**Figure 5**).

Reference: Other strategies to maximize the tax benefits of a charitable contribution include gifting shares of appreciated securities in kind and making qualified charitable distributions (QCDs). For more information, see the Vanguard research paper *Charitable giving: Three elements of a successful plan.*

FIGURE 5

Bunching charitable contributions can increase multiyear deductions

Comparison of yearly deductions by strategy

	No bunching				Bunching			
	Year 1	**Year 2**	**Year 3**	**Year 4**	**Year 1**	**Year 2**	**Year 3**	**Year 4**
Standard deduction	$27,700	$28,000	$28,300	$28,600	$27,700	$28,000	$28,300	$28,600
Itemized deduction	$24,000	$24,000	$24,000	$24,000	$32,000	$16,000	$32,000	$16,000
Mortgage interest	$8,000	$8,000	$8,000	$8,000	$8,000	$8,000	$8,000	$8,000
Charitable gift	$8,000	$8,000	$8,000	$8,000	$16,000	—	$16,000	—
SALT tax	$8,000	$8,000	$8,000	$8,000	$8,000	$8,000	$8,000	$8,000
Deduction taken:	**$27,700** standard	**$28,000** standard	**$28,300** standard	**$28,600** standard	**$32,000** itemized	**$28,000** standard	**$32,000** itemized	**$28,600** standard
Total deduction (2 years)		$55,700		$56,900		$60,000		$60,600
Annual increase in deduction					$4,300	—	$3,700	—
Total increase in deduction					$8,000			

Notes: This illustration is hypothetical and is not representative of any client's account. The amounts shown for the standard deduction assume it increases by $300 each year with no other adjustments.

Source: Vanguard.

To take this strategy a step further, consider pairing the itemized deduction with additional taxable income. The additional deduction presents an ideal opportunity to reposition a portion of a taxable portfolio, convert traditional IRA assets to Roth, or just shift more contributions into the Roth account with little or no tax liability.

Health care expenses

Out-of-pocket medical expenses are deductible to the extent they exceed 7.5% of an investor's adjusted gross income (AGI).[7] One possible way to maximize an investor's medical expense deduction is to leverage a bunching strategy by shifting the payment of multiple years' worth of medical expenses into a single year. Another way is to use a Health Savings Account (HSA) in combination with a High Deductible Health Plan (HDHP).

An HSA is available only when paired with an HDHP that allows an investor to set aside money for future medical expenses. HDHPs have higher deductibles and lower premiums than traditional health insurance plans, but the benefits of the HSA may make this combination more tax-efficient now and in the long run.[8]

The money used to fund the HSA provides a triple tax advantage:

- It is fully deductible as an above-the-line deduction.
- The contributions can often be invested and grow in a tax-deferred account.
- Withdrawals are distributed tax-free when used for qualified medical expenses.[9]

An HDHP/HSA combination may make sense for investors who are in a position to pay potentially higher medical expenses out of pocket or who have minimal health care needs. The HDHP's lower premiums will provide a lower tax deduction, but the deductible HSA contributions combined with the HDHP premiums may match or exceed the deduction for premiums of a non-HDHP plan.[10]

Deductions for contributions to tax-deferred accounts—including employer plans, IRAs, and Health Savings Accounts (HSAs)—are considered "above the line," meaning they're taken before calculating adjusted gross income. These are in addition to the standard or itemized deductions.

7 AGI is gross income minus certain income exclusions and above-the-line deductions. To be deductible, total deductions must still exceed the standard deduction for medical expenses.

8 Although an HDHP/HSA combination may be tax-efficient for many investors, it's not necessarily right for everyone, depending on one's premiums, copays, and total medical expenses.

9 Understand how an investor's state of residence may treat their HSA, as different states may treat HSAs differently.

10 Additional tax implications may apply, depending on the structure of the plan.

Consider this example:

George and Lucille have two children on their health plan and are evaluating their insurance options. They have considerable assets, and the family members are in good health, making an itemized deduction for out-of-pocket medical expenses unlikely. In comparing their HDHP option with their non-HDHP option, the couple saw two clear benefits to the HDHP. First, it gave them the opportunity to contribute $7,300 to a tax-deferred account. Second, the HDHP/HSA combination provided an additional $6,143 in tax deductions for the year (**Figure 6**).

FIGURE 6

An HDHP paired with a HSA may increase health care deductibility

Health insurance options for 2 adults and 2 children

	Non-HDHP	HDHP
Biweekly premiums	$125.98	$81.48
Tax-deductible plan premiums	$3,275.48	$2,118.48
Annual out-of-pocket deductible	$2,000.00	$5,000.00
Maximum HSA contribution	N/A	$7,300.00
Potential deduction	$3,275.48	$9,418.48
Additional deduction	—	**$6,143.00**

Notes: This illustration is hypothetical and is not representative of any client's account. Because of the hypothetical couple's income, they cannot take an itemized deduction for any out-of-pocket medical expenses.
Source: Vanguard.

Once an HDHP/HSA combination is determined to be the investor's best option, the next question is: Should the investor pay for medical expenses out of pocket, or use the HSA?

One major advantage of an HSA is that there are no annual distribution requirements, time limits on use, or required termination of the account; these factors theoretically allow the HSA to grow in perpetuity. This can make an HSA a powerful retirement-planning tool. Investors who can afford to do so can make contributions during their working years, with current medical expenses paid out of pocket. The contributions are invested and allowed to grow until retirement, when the HSA is used to cover qualified medical expenses and is distributed tax-free. This strategy both maximizes the investor's deductible medical expenses during their working years and gives them a source of triple-tax-free income during retirement.

Conclusion

A range of tax-planning opportunities may be appropriate for a wide range of investors. Understanding the mechanisms available in increasing tax efficiency is fundamental to making an investor's portfolio more tax-efficient. Once these mechanisms are understood, analyzing an investor's tax situation can illustrate specific financial planning techniques that may be appropriate to improve investor outcomes.

Appendix

Beyond the basics: A case study

Jose and Isabel Acevedo—two working parents with two children—have the following tax profile. Their financial advisor decided to use their prior-year 1040 to identify financial planning opportunities. **Figure 7** provides information that can be gleaned from the 1040. Items noted in the figure were addressed and changed for the subsequent tax year to improve the couple's tax efficiency and investment outcome.

FIGURE 7

A taxpayer's 1040 can point the way to suitable tax-planning opportunities

Sample tax profile

Ordinary Income	Original	Adjusted	Actions taken
W-2 income	$210,000	$210,000	Ordinary income from employment was not adjusted.
Corporate bond interest	$16,000	$8,000	**Original:** • The fixed income portfolio is composed entirely of taxable corporate bond income. **Actions:** • A portion of the corporate bond holdings were moved to tax-free municipal bonds. **Result:** • Taxable income decreased, affecting tax thresholds based on adjusted gross income (AGI).
Municipal bond interest	$0	$6,500	

(Continued on next page)

FIGURE 7 (CONTINUED)

A taxpayer's 1040 can point the way to suitable tax-planning opportunities

Sample tax profile

Realized capital gains	Original	Adjusted	Actions taken
Fund distribution: Short-term capital gains (STCG)	$10,000 (reinvested)	$5,000	**Original:** • Proceeds from taxable fund distributions and annual transactions (rebalancing and TLH) were reinvested. Cash was taken from the taxable portfolio using the default cost basis settings. **Actions:** • Stopped automatic reinvestment. • Changed cost basis settings to minimize taxes. • Redirected a portion of annual transactions to tax-efficient ETFs and index funds. • Redirected a portion of annual transactions to the cash account. **Result:** • Tax efficiency decreased distributions and dividends over time. • Annual transactions funded liquidity needs without additional transactions.
Fund distributions: Long-term capital gains (LTCG)	$25,000 (reinvested)	$20,000	
Sales for cash: STCG	$3,000	$0	
Sales for cash: LTCG	$7,000	$0	
Taxable income	$271,000	$243,000	Decrease in taxable income = $28,000 • An $8,000 decrease from the move to muni bonds. • A $10,000 decrease from the tax efficiency of ETFs and index funds. • A $10,000 decrease from the use of annual transactions to fund liquidity needs.
Amount reinvested	$35,000	$13,500	Redirecting proceeds from annual transactions covers: • A $1,500 decrease in bond income. • $10,000 in liquidity needs. • A $13,500 reinvestment in tax-efficient ETFs and index funds.
Available income	$236,000	$236,000	Both scenarios, accounting for reinvestment, generate equivalent income for use.

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Beyond finding information on the Acevedos' taxable income, the advisor found information about their annual deductions:

FIGURE 7 (CONTINUED)

A taxpayer's 1040 can point the way to suitable tax-planning opportunities

Sample tax profile

Above-the-line (ATL) deductions	Original	Adjusted	Actions taken
Health insurance	Premiums ($3,275)	HDHP ($1,700) HSA ($7,300) Total ($9,000)	**Original:** • Employer coverage with a non-HDHP. • Premiums are deductible. • Out-of-pocket expenses are not deductible. **Actions:** • Switch employer coverage to HDHP and HSA. • Medical expenses may be paid from the HSA or out of pocket. **Results:** • The deduction for premiums is lower. • The additional deduction for HSA contributions increases the total deduction. • Out-of-pocket expenses can be paid from deductible HSA contributions. • AGI is lower.
401(k) plan	Jose ($11,000) Isabel ($2,500)	Jose ($22,500) Isabel ($4,000)	**Original:** • Both Jose and Isabel maximize the employer match in their 401(k) plans. • Contributions to the traditional IRA are nondeductible, because income exceeds deduction limits. • Roth IRA contributions are not an option because income exceeds Roth income contribution limits. **Actions:** • All contributions are moved to the 401(k) plans and are deductible. **Results:** • AGI is below the income threshold for deductible IRA contributions. • AGI is below the income threshold for Roth IRA contributions. • Additional tax-deferred savings opportunities are opened up.
IRA contributions	($13,000)	$0	
Total ATL deductions	($16,775)	($35,500)	Increase in deductions = $18,725 • $13,000 original IRA contribution was not deductible because of income limits. • $13,000 is now deductible as 401(k) contribution. • $5,725 net increase in deductions is allowed from HDHP and HSA insurance.
Adjusted gross income	$254,225	$207,500	Decrease in AGI = $46,725 • $28,000 from the decrease in taxable income. • $18,725 from the increase in ATL deductions.

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FIGURE 7 (CONTINUED)

A taxpayer's 1040 can point the way to suitable tax-planning opportunities

Sample tax profile

Standard or itemized deduction	Original	Adjusted	Actions taken
Standard deduction	$27,700	$27,700	Standard deduction for married couples, filing jointly.
State and local taxes	$10,000	$10,000	SALT taxes are capped at $10,000, and the Acevedos can take the full allowable amount.
Mortgage interest	$10,000	$10,000	$10,000 goes to mortgage interest annually.
Charitable donations	$15,000	$30,000	**Original:** • $15,000 goes to charitable donations annually. **Actions:** • Two years of charitable donations are bunched in the first year by opening a donor-advised fund to hold the second year's donation. • The second year's donation is made from the DAF. **Result:** • The standard deduction of $27,700 is taken in year two. • The two-year impact allows for an additional $7,000 in deductions. • The two-year total deduction is $77,000, versus $70,000 in the original approach.
Total itemized deduction	$35,000	$50,000	In both cases, the couple take an itemized deduction.
Taxable income	**$219,225**	**$157,500**	
Ordinary income tax	$31,805	$20,865	The Acevedos' ordinary income tax decreased by $10,940.
Capital gains tax	$4,800	$3,000	Their capital gains tax decreased by $1,800.
Total taxes due	$36,605	$23,865	Their total taxes decreased by $12,740.
Roth IRA contributions	N/A	$12,740	Although not illustrated, the above-the-line changes enabled the option of Roth IRA direct contributions.
Marginal tax rate	22%	22%	The Acevedos stayed in the same marginal tax bracket.
Effective tax rate	13%	10%	Their effective tax rate, however, decreased by 3 percentage points.

Note: This illustration is hypothetical and is not representative of any client's account.

Source: Vanguard.

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Investments in bonds are subject to interest rate, credit, and inflation risk.

Withdrawals from a Roth IRA are generally tax-free if you are over age 59½ and have held the account for at least five years; withdrawals of earnings taken prior to age 59½ or five years may be subject to ordinary income tax or a 10% federal penalty tax, or both. (A separate five-year period applies for each conversion and begins on the first day of the year in which the conversion contribution is made.)

Nonqualified withdrawals from a health savings account may be subject to taxes and a 20% federal penalty tax.

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