Tom Mullooly: Welcome back to the podcast. This is episode number 391. I am flying solo today. This is Tom Mullooly, and we are recording episode 391 just after the most recent tax filing deadline here in 2022. So 2021 taxes for many people are in the books. It's done. Yes, there's a certain percentage of folks that do file an extension and they will have an additional six months to file, up until October 15th. Getting an extension does not necessarily give you a free pass to not pay taxes owed. You will still need to pay your taxes by the tax filing deadline, or at least fit in the... You need to fall into the range of having enough money either withheld from your paycheck or estimated payments or sending in a payment to meet the obligation of paying your taxes.

Tom Mullooly: Interesting note, you do pay interest in penalties on the amount that you owe on your taxes. However, the penalty is technically larger if you don't file your taxes. And that's something that a lot of people overlook. So absolutely file your taxes, pay the taxes that you owe or come as close as you can to it. If you do have problems coming up with money to pay your taxes, you really should be talking with a financial planner or an advisor to help you get on track. And now that filing taxes is fresh on everyone's minds here in the spring of 2022, it's not a bad time to take a look at things that you need to keep in mind as we roll through 2022.

Tom Mullooly: A lot of folks want to figure out what they did wrong or what they could change on their taxes after the barn has burned down in January. After the tax year is over, for most purposes, it really is too late to make changes for your taxes. So one of the things that we try to remind folks is to not get hung up on letting taxes drive your investment decision. Nobody likes paying additional taxes. Of course, working with a planner, working with an advisor, you want to try and minimize those tax events where you're recognizing taxable income.

Tom Mullooly: But a lot of people are simply afraid of the concept of having to pay capital gains taxes or having to pay additional taxes over and above what they've earned in their income or in their retirement income. And so I wanted to just take a little time today and talk about capital gains tax rates. So when we talk about long-term capital gains, these are assets that are held longer than 365 days. So a year and a day, you qualify for long-term capital gain tax treatment.

Tom Mullooly: And in 2022, as in 2021, there are three tax brackets for capital gains. And the first bracket is the zero tax bracket. So there are three levels. There's 0%, there's 15%, and then there's 20%. And technically you could say there's a fourth one because depending on your income, you may have to pay the Medicare surcharge on top of your capital gains if you're in the highest tax brackets of all. But I want to go back and talk about this because there's a lot of folks who say, "I can't sell this stock because I'm just going to be paying too much in taxes."

Tom Mullooly: And so, remember they're based on, or I shouldn't say remember, you may not know that your capital gain tax rate is based on your taxable income. It's not based on your adjusted gross income, it's based on your taxable income. So there's a difference between adjusted gross income and taxable income. Your adjusted gross income is what historically you used to find at the bottom of page one of the old tax returns.

Tom Mullooly: And so the way it's calculated now is if you're married filing jointly, and in 2022 you get that $25,900 deduction for two filers, married filing jointly, so the difference between your AGI and your taxable income is that standard deduction. In this year, it's $25,900. It's half of that for single filers.

Tom Mullooly: Let's take a look at this. So if you're a single tax filer in 2022, if your taxable income is less than $42,000, the exact number is $41,675. If your taxable income is less than, I'll just say $42,000, your long-term capital gains tax rate, zero, zero. You can sell stocks and other investments that you've held for more than a year and not have any capital gains. That's really important. So if you're a single tax filer and you have taxable income, I'll just say $42,000, and up to $459,000, almost a half a million dollars in taxable income, you're a single filer, your capital gains tax rate, 15%. 15! The 20% capital gains tax rate for a single filer does not kick in until your taxable income exceeds $459,751. There's a lot of misunderstanding. A lot of folks still think that they're going to pay 20% in long-term capital gains. You may pay zero or you may pay 15%.

Tom Mullooly: Let's take a look at if you are married filing jointly. Again, we don't use adjusted gross income, we use taxable income to calculate your capital gains tax rate. If you're a married filing joint couple, and you have taxable income of less than $83,350, so under $84,000, and you're married filing jointly, your capital gains tax rate, zero. Zero. You will not pay capital gains if your taxable income is less than $84,000. The exact number, $83,350. If you're married and filing jointly and your taxable income is anywhere between $83,350 and $517,000, your capital gains tax rate will be 15%.

Tom Mullooly: I can't tell you how many people we meet who are married filing jointly, taxable income, $150,000, they think that they're paying either their effective tax rate or a 20% capital gains rate. And the most common refrain that we hear when we start talking about these numbers with clients, "Oh, that's not so bad. It's not as much as I thought. Oh, okay, I can handle that. All right. Great." Very important to understand if you are married filing jointly, and your taxable income is 517 grand or less, that's taxable income, not total income, taxable income, you're in the 15% tax bracket for long-term capital gains. Now, if you're right there at the threshold, understand that if you add back your standard deduction of $25,900, your adjusted gross income can be as high as $543,000, you're still going to be paying just 15% in long-term capital gains.

Tom Mullooly: So I wanted to just take another twist here, another bend in the road, and talk about what if you're married filing separately. We don't see this too often, but I did want to take a moment to talk about this. If you are married filing separately and you have taxable income up to $41,675, same as a single tax filer, zero. You're going to have a zero capital gains tax rate.

Tom Mullooly: However, a moment ago, I just mentioned that if you're married filing jointly, you are going to pay just 15% on long-term capital gains if you have taxable income, married filing jointly, up to $517,000. Well, the threshold for married filing separately is half of that. It's $258,000. So the threshold gets a lot lower if you are married but filing separately. And while we're talking about married filing separately, again, as I mentioned a moment ago, we don't see this very often, but there is some strategy that comes with married filing separately.

Tom Mullooly: There are some cases where it may be a smart move. But in many cases, it's very costly to do something like that. And a lot of times, when we've run into folks that are married filing separately, we can often categorize these folks as folks who tend to over-strategize. You probably know a few people like this in your life who instead of say just investing for the long-term, they want to know exactly what they should be doing on Tuesday compared to Friday, compared to next month or next week. What does the Elliott Wave theory say? What does my horoscope say?

Tom Mullooly: Some folks just want to make simple things really complicated and sometimes married filing separately is a little bit of a, well, I'll say a flashing yellow caution light, especially for advisors. It usually indicates that there's something going on that we ought to know about. And so a lot of times people, they'll file the returns and use the classification as married filing separately because there's a pending divorce, something your advisor ought to know, something your financial planner really should know.

Tom Mullooly: Another reason why someone might file married but filing separately is that there may be a situation where one spouse needs to shield some tax liabilities from say some questionable transactions. So one spouse gets kind of shielded from these questionable transactions. So look, there's a lot of disadvantages to doing this. You lose tax credits. There are more limits on deductions. So it's really not something that you see very often. If there is, at least for advisors, you're going to need to pry a little more, prod a little more conversation, try and get some more information on why this particular situation requires married filing separately. So you're going to give up the opportunity to use an earned income tax credit.

Tom Mullooly: If you have children, you're going to lose the opportunity to use the child tax credit, or at least the full credit. Only half of the credit is available. You're going to lose the child and dependent care credit. You may still get a partial credit for that, but you lose the full credit that comes with that. You're also going to lose any of these deductions and credits that come with education. So the American Opportunity Credit, the Lifetime Learning Credits, deducting student loan interest, deducting tuition and fees. I mean, all of these things just go away or they're restricted. And so you really, really need to think about why you want to be in a situation where you're married filing separately.

Tom Mullooly: One other one that I think a lot of people miss is that if you are married filing separately, the traditional IRA phase out, the deduction, it's almost zero in the sense that the phase out between a lower adjusted gross income ranges from 0 to $10,000. And so you're almost basically restricted from making a traditional IRA and deducting that contribution to the plan.

Tom Mullooly: Another problem with married filing separately is that both spouses have to choose the same methods of recording their deduction. So for example, if one spouse decides that they want to itemize their deductions, the other spouse has to take the same route even if those itemized deductions wind up being less than the standard deduction that they're free to take. Again, we don't see married filing separately very often in our practice, but usually there's a reason behind it. And hopefully it's not from over-strategizing. There may be situations where a married couple is separated or there's a pending divorce, or there may be some kind of liability issue that's going on. So married filing separately usually is an indicator to us that there's more to the story and we need more information with that.

Tom Mullooly: But circling back to these capital gains tax rates, you don't want to be in a situation where you're day trading or actively making investment changes in a taxable brokerage account. We've unfortunately met some people who have attempted to do more active trading in a regular taxable account and it just leads to more, not necessarily problems, but complications. There's a lot of folks that have some regret. They look back and say, "Wow, I made some money, but I wound up giving a lot of it back to the government in taxes."

Tom Mullooly: Remember that if you don't hold an asset as long as a year, meaning your holding period, say you bought something on Monday and you sold it on Friday, or you bought something in January and you sold it in October, if your holding period is less than a year, you will pay ordinary income taxes. That whatever your ordinary income tax rate is, that is the rate that you're going to pay on short-term gains.

Tom Mullooly: And if you're unlucky and lose money in some of your transactions, just also keep in mind, we've talked about long-term capital gains and short-term capital gains, but your capital gains losses after netting all of the transactions together, your long-term capital losses are limited to $3,000 a year. Say you have $30,000 in losses. You can only use $3,000 this year against your taxes. The remaining $27,000 gets pushed forward into next year and future years until it is used up.

Tom Mullooly: So I know that, just a little bit of trivia here, the long-term capital, well, I should say capital loss limit of $3,000 a year was set in 1974 and it has not been changed since then. So we're talking about almost 50 years where you can't take losses. I think some Congressman really wants to make a name for himself. This is something that they ought to pick up the mantle and run with because this has not been indexed for inflation.

Tom Mullooly: There's a lot of folks talking about inflation right now. This is one area where we could really use some help. Even if they were to raise that annual capital loss limit from $3,000 to even $10,000, it would allow some people to say, "Hey, you know what? I want to clear up some of these losers that I've got in my account, or some of these things that just aren't working out, or I want to net some longer term gains that I've got with some losers that I've got and be able to take a bigger loss against my taxes."

Tom Mullooly: These are areas that just seem to get ignored when it comes to tax time. So long-term, I shouldn't say long-term, but capital losses limited to $3,000 per year. Everything else gets carried forward into the future. Long-term capital gains rate, meaning you held the asset for more than a year, 365 days. Again, it's a big surprise when we tell people if you're a single filer and your taxable income is under $42,000, you're probably going to pay zero on capital gains. If you're a single filer and you have up to $459,000 of taxable income, you are in the 15% long-term capital gains rate. Beyond 459 grand in taxable income, you're paying 20% in long-term capital gains.

Tom Mullooly: If you're married filing jointly, again, up to $517,000 in taxable income, you're in the 15% tax bracket for capital gains, not the 20% number that a lot of people easily throw around. So just be careful when it comes to this. Again, now that the idea of filing taxes and paying taxes is fresh in everyone's mind, it's not a bad time to be thinking about what you can be doing the rest of the calendar year to improve your tax situation. That's going to wrap up episode 391. As always, thanks for listening, and we're happy to answer your questions and take your calls. We hope to talk to you soon.

Speaker 2: Tom Mullooly is an investment advisor representative with Mullooly Asset Management. All opinions expressed by Tom and his podcast guests are solely their own opinions and do not necessarily reflect the opinions of Mullooly Asset Management. This podcast is for informational purposes only and should not be relied upon as a basis for investment decisions. Clients of Mullooly Asset Management may maintain positions in securities discussed in this podcast.