Hons Tax Associates
Fall 2022 Newsletter

In the last few weeks there have been tax related news worth noting so I am issuing a September tax newsletter for my clients. All current and last two filing seasons newsletters are on our website as pdf files you can download https://hons-tax.com/blog/

In this Newsletter:

- relief penalties 2019 & 2020 tax returns
- forgiven student loans
- electric cars
- Social Security retirement (each newsletter I try to write more in depth about one subject, this is a longer piece, worth reading if you are near retirement or retired)

Relief penalties 2019 & 2020 tax returns

IRS is waiving the penalty for not filing in time 2019 and 2020 returns:1040s, some of the nonprofits returns (not 990 and 990EZ), partnerships, S Corps and others, if these returns are filed by Sept. 30, 2022. The relief is automatic and there is nothing that one needs to do to get it. If you've already filed your return and paid the fine, you should get a refund. The penalty for not paying taxes in time is not included in the relief (only the penalty for not filing in time)

Forgiven student loans

So the Biden administration announced in August a student loan debt cancellation program.

- this program applies to student loans held by the US department of Education (not private loans) to an amount of $10,000 with the conditions of an Adjusted Gross Income (AGI) of less than $125,000 for singles, $250,000, for Married Filing Jointly (MfJ) in **either** of Covid years 2019 and 2020 (one of these two years with these conditions filled is enough). If the borrower received a Pell Grant, the amount goes up to $20,000. For applicants claimed as dependents, we expect the parents' AGI to apply. The loans have to be disbursed by June 30, 2022

- The online application for this is expected to open in October. One can signup on https://www.ed.gov/subscriptions to be informed on when the online application open (it seems to work I tried it)

-These cancelled loans amounts **will not** be taxed federally (normally a cancelled loan is income for the IRS). However, we don't know yet for the states (some states may consider this taxable income).

- There are also dispositions to reduce loan payments amounts when lower income. Below is a link to a good New York Times article with details and many questions answered:

https://www.nytimes.com/2022/08/24/business/biden-student-loan-forgiveness.html

Electric cars

I wrote in last month newsletter (https://hons-tax.com/blog/) about the main provisions of the "Climate, Tax and Health Care package. Let's look more closely at the provisions of the new law applying to electrical cars.

- good for the buyer:

. the new credit applies starting on Aug 16 2022 (except …see below)

. the limitation of the previous tax credit for the number of cars sold (when over 200,000 electrical vehicles sold) is removed but starting in 2023 only (Tesla has exhausted the tax credit due to the numbers of cars sold). The new credit, as the previous one is up to $7,500 for new cars but also $4,000 for used electric cars (nothing before).

. starting in 2024, the buyer can deduct the tax credit directly from the purchase price (without waiting to file a tax return to get it)

- but more complications:

. the new credit applies only starting in 2023 for manufacturers who exceeded 200 000 electrical cars sold ie Tesla, Toyotas and GM

. the manufacturer' suggested retail price cannot exceed $55,000 for sedans and $80,000 for SUVs, vans and pickups.

. AGI taxpayer has to be under 300k Married filing Jointly, 225k Head of Household, and 150k single filers for new electric cars, and half of the above in each category for used cars

. there is uncertainty as to which cars qualify due to the conditions in the law:

all vehicles must be built in North America (US, Canada, Mexico), this currently eliminate Kia, Hyundai, Genesis, Audi, Porsche, Subaru and others

half of the credit will depend on where the battery components are made: need to be 50% US, going up to 60% in 2024, and the raw materials used: 40% (climbing every year) must be sourced or recycled in the US or a country that has a US free-trade agreement, also none of the battery components can come from restricted countries (Russia, China, North Korea, Iran)

. No electric vehicle made today meet both these production and material sourcing requirements (giving half the credit)

. the tax credit for used electrical cars is the lowest of 30% of the price paid or $4,000 and has other restrictions (on top of the income restrictions noted above): car at least 2 years old, not available to dealers who buy for resale, price $25,000 or less, can be used once only for a given vehicle, purchase at dealership only (not private sales), starts Jan 1, 2023, not available to businesses

- as you can see, and I would say as most things the government does, this is far from being simple…

This article explains everything in detail.

https://www.edmunds.com/fuel-economy/the-ins-and-outs-of-electric-vehicle-tax-credits.html

Social Security Retirement

The information below is summarized and does not cover everything. Feel free to call me (303-929-8090) for custom situations.

- SS benefits are moderate. The maximum (that very few people get) is about $40,000 a year, most people get in the 12,000 to 32,000 range. According to Social Security, its benefits make up (globally) about 1/3 of retirees' income

- to collect SS benefits, one needs to be 62 and have paid in for at least 10 years (collecting early is often not the best strategy: lower payments). SS benefits are calculated using a retirement age in (between 66 and 67 years old now),

- maximum monthly benefits are when waiting to be 70 to claim (benefits increase about 8% a year from retirement age to 70). If claiming earlier and wanting to change that decision (to get higher monthly payments and /or when having originally unplanned other income), one (when at retirement age) can suspend its benefits until later.

Main factors to consider:

. other retirement income and savings
. retirement age and health status
. marital status (possibility of getting half spouse SS benefits)

- When married it usually makes sense for the highest earner to wait longer to claim. Spouse has the choice to claim 50% of spouse benefits (if higher that his/her own SS benefits). Also when divorced and had been married at least 10 years, one can claim 50% of ex's benefits.

<u>Taxation</u>

- Taxation of SS benefits is at first confusing for most people. Also it is not calculated through a simple formula, which is why, unless the situation simplifies (not taxed or clearly taxed at the maximum), tax numbers cannot be obtained right away. The same calculations apply to SS disability benefits. SSI (Supplemental Security Income) is on the other hand never taxable.

- The lawmakers decided a long time ago that retired people who have no, or little other income should not have to pay tax on their Social Security benefits (which is never high and is their main or only retirement income).

- But they decided that people who have substantial other income, not having to rely mainly on SS for their retirement, should pay tax on their SS benefits, going from 0% of SS being taxed to a maximum of 85% of SS being taxed. This is calculated through a (confusing) SS worksheet (in IRS Pub 915, easy to google) we are happy the tax software does for us. The way this works is:

- <u>simplest</u>: if all (annual) other income (**including** tax exempt interest income **and** capital gains) + ½ SS benefits (this being called the "provisional income") is less than 25k (singles) or 32k (Married filing Jointly, noted MfJ here), **none** of the SS benefits will be taxed. These numbers have not been actualized for many years

- when the provisional income is over 25k (single) or 32k (MfJ), the SS worksheet computes how much of the SS is taxable to a <u>maximum of 85% taxable and</u> depending on both the other income and the SS benefits. 50% is reached at a provisional annual income of $34,000 (single) and 44,000 (MfJ). The taxable SS is then added to the other income for the Adjusted Gross Income used to compute the tax return. Note that married people filing separately are penalized (check SS worksheet or call me for details)

- Below are four simple examples of the <u>other income</u> at which <u>85% of SS taxed is reached</u> (again it is not a simple formula), numbers are annual in thousands.

Single with 12k SS benefits: all other income = 34.7k (10.2k of SS taxable)
Single with 20k SS benefits: all other income = 38.7k (17k of SS taxable)

MfJ with 32k total SS benefits: all other income = 53.0k (27.2k of SS taxable)

MfJ with 45k total SS benefits: all other income = 59.5k (38.25k of SS taxable)

- As you can see:

. one does not have to have that much other income for 85% of his/her SS benefits being taxed

. people with higher SS benefits are allowed a higher total income before their SS benefits get taxed at 85% (but the higher SS benefits imply higher tax with also possibly a higher tax rate).

. If you went through the explanations and examples above, you realize that (like most things in tax…), and here also the lawmakers did not make this simple. Most retired people benefit from using a tax preparer or at least a tax software (vs doing the SS worksheet and return by hand)

- Given the above, the situations we see relatively often are retired persons or couples who are not big spenders and had basically optimized their tax, their tax return looking similar every year with a small refund if they withheld or possibly a small amount owed if they did not. Then one year they decide to pull (taxable) money out, to pay for a remodeling, give money to their grandkids, medical, and/or other good reasons. This could be via pulling money out of a 401k, selling a stock with a sizeable capital gain, selling a property /rental and/or other taxable income.

- What happens then in their tax return is that their extra income gets them from close to zero Social security taxable to 85% taxable, adding to their Adjusted Gross Income (AGI) on top of the other income received, possibly also getting them in a higher tax bracket, and generating a very unpleasant and unplanned large tax bill. Below is one simple example so you can see how fast this can happen:

- MfJ couple with 40 k of SS security (between the two of them) and 22k of other taxable income, no tax-exempt interest income (there could be Roth IRAs distributions, not taxable and not taken into account in the SS worksheet): only $5,000 of their SS is taxed, their AGI of $27k is less than the standard deduction ($27,8k MfJ over 65) and they pay <u>zero</u> Federal and Colorado income tax.

Then, only in this one year, they pull an extra 35k (not a huge amount) from their 401k. Then: 85% (34k) of their SS is now being taxed, their AGI is now 91k (22+35+34). Assuming using the standard deduction and no other things, their Federal tax bill is now close to <u>$7,200</u> even though their marginal tax rate is only 12%, and their Colorado tax bill close to <u>$1,400</u>.

In similar cases it is best to do a bit of tax planning to figure the taxes and possible options. Spreading the extra income over two calendar years (or more) if possible, can often generate sizeable tax savings.
