Hons Tax Associates llc

December 2022 Tax Update & Newsletter

I addressed in my October Newsletter (available on hons-tax.com "tax posts"), the main changes for 2022 taxes. This newsletter covers miscellaneous items, including retirement income, and is in preparation of the 2023 filing season.

2023 filing season

The IRS is expected to re-open electronic filing (also for previous years returns) in the last week of January. If a simple return and you have your W2(s), I can prepare your return before and e-file it as soon as e-filing is opened. As in previous years, the IRS is expected to issue most direct deposit refunds within 2 to 4 weeks (minimum 3 weeks when credits claimed on the return).

I recommend e-filing and direct deposits. There are many issues with mailing returns. To list a few: very long processing delays (a year is common), not being able to e-file an amended return after, manual processing by the IRS with a risk of entry errors, and in my opinion (I cannot prove this) a possible higher risk of audit for more complex returns (as an IRS employee will look at and enter the return manually and the IRS is set to receive more funding).

What works best for me is seeing you in a person for a short appointment when you bring your tax documents. I can then check with you against last year return that nothing is forgotten, new things, ask and answer questions. In my opinion, this is usually more efficient for both you and I than thick "organizers" to be filled by clients (I can email you one if you are a previous client and like to use them). Also, you all have been good at getting me missing info. after we have sat together. Emails usually work well for this. Set an appointment

I will work with a secure upload (hons-tax Dropbox account) of documents if you cannot make it to an appointment. My experience is that it is most often more work for me, and with a potential for missing things. I ask you to upload all the documents as much as possible at once. Receiving documents bit by bit over time and through different channels is hard for me as I need to figure, keep track and communicate for each return what is still missing, with many returns to do. If excessive number of communications and delays, I may need to charge extra time.

At a survey to tax professionals: "What do you think is the chance the IRS extends the 2023 filing season? (0%, 25%, 50%, 75% or more)", 65% of tax professionals answered 0% chance and 22% answered 25% chance. So the large majority of tax professionals think IRS will not extend the tax season. Last day to file will be April 18, 2023. I can also file for you an extension by that date (extension to file not to pay) to October 15

Referrals

I will deduct $25 from your tax return fee (or write you a $25 check if already paid) if you refer to me a client to whom I provide paying tax services. Please remind me at tax time! I try to take notes for it, but I don't have yet a good formal system to keep track in all cases.

Student loans holders:

Things got complicated...

After over 22 million people applied online for the student loan forgiveness (of up to $20,000 when Pell Grant, up to $10,000 otherwise), a federal judge vacated the government program, as "unlawful and an usurpation of the authority of congress" and there was also another lawsuit. The federal government appealed the judge's decision, and the legal process will take weeks, if not months to resolve, with no clear foreseeable conclusion. The US Department of Education stopped taking applications and the program has been paused until a legal resolution. The payment pause on federal student loans was extended until 60 days after the administration can implement the program again, if allowed by the courts. If not allowed, or the judicial process is not concluded by June 30 2023, the payment pause will be extended to 60 days after the earliest date (of not allowed or June 30th)

Interest charged and paid by the IRS

The IRS is increasing the interest rate they pay (on refunds when filed/paid late) and they charge (on taxes paid late) to 7% per year in the first quarter 2023. This rate was 5% for a very long time.

TAXATION OF DIFFERENT TYPES OF RETIREMENT INCOME

Each newsletter I try to cover a tax topic. Many of you are retired or thinking about retirement. If you are interested, below is a summary of the taxation of the usual types of retirement income. All this was decided by the Congress over the years and there is some logic in it. It is a summary, which can only cover general information. I am available via phone (my cell phone 303-929-8090) or email michael@hons-tax.com if questions. I am not a financial adviser, so my advice can only cover tax planning and tax aspects. I can recommend a reputable and knowledgeable Certified Financial Planner (see at bottom of Newsletter)

Traditional IRAs and 401ks

These are tax-deferred ("defined contribution") retirement accounts: generally, the contributions, when made, reduce the income and so the tax, distributions (reported on the 1099R forms you receive) are taxable at ordinary income tax rates. Required Minimum Distributions (RMDs) amounts, at age 72 and older, are normally calculated by the financial institution. One can always withdraw more and needs to decide the withholdings of federal and state tax. I can help for the withholdings.

2 main caveats:

- Distributions before age 59$^{1/2}$ bring an additional 10% tax penalty with a few exceptions.
- When contributions were not deductible, either simply above the maximum allowed each year or because of one of the income phase-outs, one then has a "basis" in his/her retirement account: the after-tax money put in, which should then logically not be taxed when distributed. This gets more complicated than most people think, and I advise not to do it for the following reasons:
    - the financial institution cannot in most cases keep track of this basis because it came from the tax return(s) with income phase-out rules (unless a very simple over the yearly maximum contribution). It is almost never historically kept track of in the tax returns.

    - if you change financial institution (rollover for example), the little information the original institution had is lost in most cases.
    - So you need to keep track yourself with a spreadsheet of the non-deductible contributions made, and this could be for 10, 20, 30 years, or even more. Very few people want to do that. Only with this information, your tax preparer can do a manual proration at distribution in your tax return and modify the 1099R received to show a nontaxable part.
    - If this basis is lost (not kept track of), at distribution one can only report in the tax return the 1099R as is and the taxpayer would then pay tax years later on after-tax money, in effect a double taxation.
- I wanted to explain this point in detail because many people are not fully aware of this and often simply think "I can always put money in my IRA and it is always a good thing""

Roth IRAs and 401ks
So the logic is: no income deduction when money contributed ("after-tax" money), but no tax when the money is distributed / withdrawn, <u>including</u> the earnings generated over the years when following two very simple conditions.

I find the way this is explained in the IRS publications and by most confusing, so let me explain it in a way that I find clearer:
- The money one put in will <u>never-ever</u> be taxed when withdrawn
- For the <u>earnings</u> generated by the money put in to not be taxed when withdrawn, the two simple conditions are to be age over 59 ½ and to have had the Roth account for over 5 years.
- When one or two of the conditions are not met, it gets more complicated with the earnings withdrawn subject to tax and a possible 10% penalty.

Pensions
These are also called "defined benefits retirement plans". Whether governments or private (less and less), they are generally fully taxable at ordinary income tax rates. When there were after-tax contributions made, it is in the best case reflected in the 1099R (with a non-taxable part), otherwise the tax preparer has to make a calculation (actuarial "simple method") modifying the 1099R in the tax return on order to show the non-taxable part of it (which is usually small)

Social Security Benefits
Depending on the other income in the year, 0% to 85% of the SS benefits paid are taxable, calculated through a worksheet in the tax return. Please refer to my September 2022 Newsletter on hons-tax.com "tax posts" for detailed explanations with examples.

Life Insurance
Life insurance proceeds received by a beneficiary are almost never taxable
A life insurance surrendered for cash by its holder can be taxable (it is not simple)

Annuities
Annuities can be complex instruments and I cannot advise on them at all. Many annuities offer added benefits like a guaranteed return and other features and the cost of these added benefits may not always be clear. I would suggest reading the small print and getting a second opinion by a certified financial planner.

In general, your (after-tax) principal is tax free at distributions, but the earnings are taxed as ordinary income. This is reflected in the 1099R you receive at distribution. If the principal was rolled over from a tax deferred account (continuing the deferment), it is then logically taxed as ordinary income at distribution.

Sale of stocks, bonds, mutual funds
- held more than a year: long term capital gain tax rate (with its own tax brackets, lower tax, and starting at zero tax): refer to my August 2021 Newsletter on hons-tax.com "tax posts" for brackets (or simply google it), brackets have not changed much in the last 2 years
- held up to a year: ordinary income tax rate

Most mutual funds generate capital gains which basically cannot be estimated in advance: the fund manager buys and sells stocks and bonds in the mutual fund depending on the fund goal, his/her perception of the market, clients' contributions and withdrawals, keeping close to an index for indexed funds, etc... Although some funds can "churn" more than others, the capital gains generated, depending on so many parameters, can vary a lot from one year to another for the same fund. The good news is that these capital gains are always considered to be long term (imagine the complications of keeping track without this simplification)

If there is a net capital loss for the year (netting capital gains and losses in the order required), one can only claim $3,000 of the loss in the current year, the rest is carried forward with its character (short or long term). Financial advisers can advise on "tax loss harvesting" when useful.

The "wash sale" tax rule: in a nutshell if one sells a security at a loss and buys the same security within 30 days (before or after), the loss cannot be claimed for tax. The basis of the security purchased is however stepped up by the loss not being allowed. The logic for this is that the lawmakers did not want people to be able to show a loss for a tax deduction, while maintaining substantially the same position in the security. This is always reported by the brokerages for stocks, bonds etc. (but may not be for crypto)

Crypto
Although not a usual retirement income, a word here about Crypto currencies, which come in many flavors. They are treated by the IRS as an investment: capital gain (short or long term) taxed at sale. One needs to check a box in the return if selling transactions made. I personally consider these very speculative. A complication that one may not be aware of is that (as stocks) there are different methods to figure out the basis when selling. The most well known is FIFO: First In - First Out, but there are others acceptable methods to the IRS. Some crypto brokerages report the information the way IRS wants it, but some do not. Basis calculations, if not reported by the brokerage, can get quite complicated when many trades are made year after year.

Dividends
A majority of stocks (in essence the traditional ones, I would say) generate dividends to their shareholders and so do a majority of mutual funds through their holdings. Without going into special cases, the dividends paid out by US publicly traded companies and companies traded in the US are “qualified dividends” taxed only at the long-term capital gain rates: the lawmakers wanted to favorize these. Non-qualified dividends are taxed at the ordinary income tax rates. This is reported to you on the brokerage composite statements or on a 1099DIV.

Interest
Interest paid by savings accounts, CDs, bonds etc. are taxed at the ordinary income rate. Municipal bonds interest is exempt from federal tax (and state tax if resident state)

Investment Income
Capital gains, dividends, interest (and other passive income) are considered “investment income” and there is an extra “Net Investment Income tax” of 3.8% on the lower of the investment income and the AGI over 250,000 (married filing jointly) or $200,000 (filing single).

US Saving Bonds
I cannot get into details here. Most of these are taxed (the interest earned) when they are redeemed / mature and are state tax exempt. The interest paid may be federal tax exempt (subject to an income phase out) if paying education for taxpayer, spouse or dependent only.

Sale of home
Most people know this: if your primary home and you lived more than 2 years (really 24 months: can be intervals) in the last 5 years (60 months) before closing, up to $500,000 of the capital gain at sale is exempt from tax (when married) or $250,000 (when single). This is simple in most cases but can sometimes get a bit more involved to figure (divorced owners, basis when inherited or gifted house to one of the spouses, large improvements made, etc). Also one has to wait 2 years before using this exemption again on another house.

When all the capital gain is excluded. I strongly recommend still including it in the tax return (Schedule D and worksheets to be done). It is not a requirement, but when not done the IRS has the nasty habit of sending a letter 2 or 3 years later (from the 1099S form they received from the title company after closing) with a very large tax bill, plus interest and penalties, taxing the full sale price of the house and assuming a zero basis. This more than gets the taxpayer’s attention… One then has to answer the IRS letter with the worksheet, schedule D and exact numbers and dates (including for the original purchase), which is harder to do 2 or 3 years later and subject to the months of delays of any IRS mail.

Reverse Mortgage
Reverse mortgage payments received are an (incremental) loan, which is not income.
(but interest paid when the mortgage is eventually paid off cannot be deducted)

I am available as needed to help you figure your last quarterly estimated payment for 2022 (due January 15), the tax effects of the sale of a property or other capital gains or losses, and other tax consulting or planning.

Thank you to all my small tax practice clients
Wishing you a Happy Holiday and a joyful New Year!

Michael

A Certified Financial Planner I recommend for investments questions: Tyler Richey assetsolutionsria.com