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Top Story Synopsis

- More people of retirement age are experiencing higher-than-expected marginal tax rates due to the complex way Social Security is taxed, exacerbated by an inflation-driven increase in both Social Security and non-Social Security income
- The complex system for taxing Social Security means that the actual rates at which other income is being taxed are hidden and can be more than double the advertised rates
- Taxpayers may have options for mitigating these unexpected taxes by evaluating when to begin taking Social Security and, especially, shifting more retirement funds to Roth accounts

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Wealth Creation Strategies

Reconsidering the Pre-Tax Retirement Plan

Increasing numbers of taxpayers are experiencing higher than expected marginal tax rates[1] during their retirement years. There are two interrelated reasons for this: (1) the way Social Security ("SS") has been taxed during the last four decades; and (2) monetary inflation, which caused both Social Security and non-Social Security incomes to increase substantially over those decades. Additionally, the use of contributory pre-tax retirement plans resulted in a large shift of incomes from working to retirement years. Long touted as a great tax shelter while working, such plans are primarily responsible for creating exorbitantly high tax rates for many with modest retirement incomes.

Retirement incomes have increased while the dollar amounts of income at which SS starts to get added to the **taxable base**, which is non-SS income plus the taxable part of SS, have never been increased. Because of this, the goal of being taxed at lower rates in retirement than during working years has gone partly if not largely awry.

To understand how taxpayers capitulated to unreasonable tax rates in their retirement years requires learning a bit of history of retirement plans, the convoluted taxation of Social Security, and how sky-high marginal tax rates are almost entirely hidden from view.

Contributory retirement plans largely replaced employer pensions

With the slow demise of most private pension plans, which proved to be unsustainable due to their expense, pre-tax retirement plans to which employees could contribute became popular. These "contributory" plans included traditional IRAs, 401(k)s, 403(b)s and similar plans. Workers could save tax on their contributions at 25%, 28% and higher federal marginal tax brackets. When first introduced, little retirement income was expected other than vested modest fixed-income pensions and a bit of income from the new plans. Social Security income was far less than amounts retirees receive today, and such income was non-taxable until 1984. Because everyone assumed withdrawals from the new pre-tax plans would be taxed at 15%, 12%, or even zero rates in retirement, contributions to those plans seemed like no-brainers.

The Individual Retirement Account (IRA) was created as part of the 1974 Employee Retirement Income Security Act (ERISA). A $1,500 yearly contribution and deduction was allowed for a limited number of workers. When eligibility was expanded from 1981 through 1986, IRAs became such an incredibly popular "tax shelter" that, in 1982, one financial writer described IRAs as "the biggest tax break in history."[2] Annual contributions and deductions were incrementally increased to a maximum of $7,000 for 2024, with greatly expanded eligibility. Most non-working spouses, who were almost entirely excluded until 2006, became eligible for full "spousal IRA" contributions in 2007. "Catch-up" contributions for workers age 50 and over began in 2002 at $500 per year, increasing to the current $1,000 in 2006.

Pre-tax employer plan contributions via 401(k)s were inadvertently created by the Revenue Act of 1978, which allowed "deferred pre-tax compensation." The new Internal Revenue Code section, 401(k), was apparently written in a way hardly anyone could comprehend, so it initially went unused. In 1981, benefits consultant Ted Benna (an outside-the-box thinker) wondered whether this provision might allow earnings, via payroll contributions, to be shifted to a retirement plan from which future withdrawals could be taken, thereby deferring the tax until retirement. After researching this idea and concluding it had merit, he proposed the concept to a client, who rejected the idea. Seemingly not having any other clients willing to try it, he opted to implement the first 401(k) for the employees in his own office.[3] Employee contributions were capped at $7,000 in 1986, $10,000 in 1998, and gradually increased (due to inflation adjustments) to $23,000 for 2024. The catch-up provision for those ages 50 and over, which started at $1,000 in 2002, is now $7,500.

How is Social Security income taxed?

For nearly 50 years from its inception in 1935, Social Security was non-taxable. Beginning in 1984, up to 50% of Social Security was taxed, but only 10% of recipients paid tax on any part of those benefits. The maximum taxa-

ble SS was increased to 85% of gross SS starting in 1994. The percentage of SS recipients paying tax on some or all of SS income increased every year, with over half of recipients paying tax on at least some SS income today, largely at the 85% phase-in rate.

SS income begins to phase in to the taxable base when non-SS income plus 50% of gross SS benefits exceed a modest $25,000 for single and head of household filers (which would be roughly $75,000 today if the threshold had been inflation adjusted since 1984), and $32,000 (around $96,000 if inflation adjusted) for joint filers.

SS is phased into the taxable base at an 85% rate once non-SS income plus 85% of gross SS exceed $34,000 for single and head of household filers (roughly $68,000 had the threshold been adjusted for inflation since 1994), and $44,000 (around $88,000 if inflation adjusted) for joint filers.

Prices of goods and services have tripled since 1984 and doubled since 1994. The dollar amounts at which SS becomes subject to tax have never been inflation adjusted.

This method of taxing Social Security and the fixed dollar amounts where it becomes taxable are largely responsible for substantially increased marginal tax rates for most retirees. The increased marginal rates were unexpected when Social Security was first taxed four decades ago because both Social Security and non-Social Security incomes were much lower than today. Increased retirement income and fixed dollar thresholds gradually created phantom but very real marginal tax rates wildly exceeding advertised ones. Many retirees to this day are not aware that their SS income can be taxed, much less at rates of 22.2%, 40.7%, or higher.[4]

Because the taxable amount of Social Security is obfuscated behind a complex calculation, and marginal tax rates are touted as if they are the "real rates" for those at various income levels, the true marginal tax rates are difficult to see and understand. Those in the 10% marginal bracket would logically assume $1,000 of additional non-SS income would result in $100 ($1,000 x 10%) of tax, but that is true only for those retirees whose income is below the point at which Social Security starts to get phased into the taxable base. At relatively low incomes, each $1,000 of additional non-SS income subjects as much as $850 of SS to the taxable base; the total additional income subject to tax, then, is $1,850. This can create as much as $185 of tax on an additional $1,000 of non-SS income for someone in the advertised 10% marginal bracket, which is a hidden (but real) 18.5% marginal tax rate ($1,850 x 10% = $185; $185 / $1,000 = 18.5%). The same math reveals that $222 of tax can be created on an additional $1,000 of non-SS income when in the advertised 12% marginal bracket, a hidden (but real) 22.2% tax rate ($1,850 x 12% = $222; $222 / $1,000 = 22.2%). And, for those whose SS has not been fully phased into the taxable base when entering the advertised 22% marginal bracket, $407 of tax is assessed on an additional $1,000 of increased non-SS income, a hidden (but real) 40.7% rate ($1,850 x 22% = $407; $407 / $1,000 = 40.7%).

Why didn't anyone notice progressively escalating marginal tax rates on Social Security recipients?

Although I saw a smidgeon of this decades ago, and even wrote about it in issue # 44 of *Wealth Creation Strategies* in 2011, exorbitant marginal tax rates for SS recipients were rare. Inflation was relatively tame. The bull market of the 2010s, which was largely responsible for the massive increase in retirement plan assets (from which increasingly large withdrawals would ultimately be taken), had barely begun. I never saw a class or seminar mentioning this phenomenon, much less devoted to its analysis. In the early 2010s I saw increasing numbers of single taxpayers get slammed at 46.25% hidden tax rates on relatively insignificant "chunks" of income. No joint filers were getting hit at this rate. The 2018 Tax Cuts and Jobs Act reduced that hidden rate to 40.7% and likely reduced the numbers of taxpayers subjected to it due to a slight expansion of the standard deduction ("slight" compared with the pre-2018 combined standard deduction and personal exemptions), and worsened it for those relative few whose itemized deductions exceeded the new standard deduction due to the loss of the personal exemption deductions. The underlying problem, however, has not been addressed since SS became taxable: inflation, which was low and relatively minor on a yearly basis, but which became significant over time due to the power of compounding. And, crucially, such rates were largely concealed, as they are today.

An example, using 2023 tax rules, may shed light on the opaqueness of the phantom-but-all-too real higher tax rates. (If this is a bit tough on the brain cells, please skip to the next subheading, and be sure to study the table below.) A single person with non-Social Security income of $60,000 and gross Social Security of $35,000 (pre-Medicare and income tax withholding) is in the advertised 22% marginal tax bracket. Adding or subtracting $14,000 of non-Social Security income (decreasing it to $46,000 or increasing it to $74,000), the true marginal tax rate is 22% of that increased or decreased income. This taxpayer is so far up and over the 40.7% marginal rate, no one notices.

However, the 40.7% rate becomes apparent when non-Social Security income is at or near $37,800, because the non-Social Security income (when gross SS is $35,000) is at the point where the advertised marginal tax rate increases from 12% to 22%, and Social Security is still being added to the taxable base at an 85% rate. Adding $1,000 of non-SS income forces an additional $850 of SS into the taxable base.

This means $1,850 of income is taxed at 22%; $1,850 x 22% = $407, which is 40.7% of the actual $1,000 increase in non-SS income. It is essential to note that SS income did not increase; only the taxable amount increased. The taxpayer stays in this bracket while non-SS income increases from $37,800 up to $46,000, at which point 85% of the SS has been fully added to the taxable base, after which the real rate drops to the advertised one and the hidden rate becomes much less noticeable. The bottom line is $8,200 ($46,000 - $37,800) of non-SS income subjects $15,170 ($8,200 x 1.85) of income to tax which, at the advertised 22% tax rate, yields $3,340

of additional tax. This is 40.7% ($3,340 / $8,200) of the actual—$8,200—increased income.

A hidden tax increase—every year

If you do not grasp this, I believe it is intentional. Congress created a byzantine system by which they could conceal real tax rates and increase taxes every year on the backs of retirees, never putting this tax increase to a vote. The number of Social Security recipients hit by this hidden tax increases every year, with virtually no one having a clue as to what Congress did or the real tax rate to which retirees are subjected. The result: responsible workers saved their entire lives thinking their tax rates would be lower in retirement, only to be tricked by the system into paying more in taxes in retirement than they saved via pre-tax retirement plan contributions while working.

This is not true for everyone, and by no means do I suggest that clients should save nothing in pre-tax retirement accounts. If it were not for such accounts, many would save nothing for their later years. Social Security recipients can earn a limited amount of non-SS income tax-free.[5] A single filer with $30,000 gross SS can withdraw (or otherwise earn) roughly $20,000, and a joint filer roughly $25,000-$30,000 of non-SS income before getting hit with the 22.2% hidden marginal rate. A single filer can have roughly $300,000 to $400,000 in pre-tax accounts (joint filers $500,000 or so) and take lifetime ratable withdrawals that may never get taxed at 22.2% and 40.7% hidden marginal rates. Also, because of phase-outs of credits and deductions, some working taxpayers may save tax at federal rates as high as 72% via retirement plan deferrals. Pre-tax retirement accounts make sense for many, but it's important to monitor pre-tax balances and weigh it against potential growth, including the number of years to retirement.[6]

Let's look at a comprehensive example (see chart below; focus especially on the first and last column) showing the various hidden tax rates for a retiree receiving $35,000 gross SS plus varying amounts of pre-tax retirement plan or pension income, which we will call "non-SS income." Using 2023 tax rates, until non-SS income is $13,000 for a single taxpayer over age 64, the tax is nearly zero. Adding $4,000 of non-SS income, bringing total non-SS income to $17,000, creates a tax of about $600, or 15% of the $4,000 increased income. Why 15%? While they are in the 10% advertised marginal bracket, they are paying tax at 10% on $2,000 of SS; the tax, then, is 10% of $6,000 ($4,000 + $2,000). This retiree pays no tax at the advertised 10% marginal bracket; they skip it entirely! Above that point it gets worse.

Add another $2,500 of non-SS income, so that non-SS income is $19,500. The taxpayer is subject to the 85% SS phase-in, which creates an additional $2,125 ($2,500 x 85%) of taxable SS. The tax increases by $463 ($2,500 + $2,125 = $4,625 x 10%). This is 18.5% ($463 / $2,500) of the additional non-SS income while in the 10% advertised marginal bracket. This is the point at which the real tax rates get ugly.

The taxpayer is subjected to a 12% advertised marginal tax rate on an additional $18,300 of non-SS income, which brings total non-SS income to $37,800 ($19,500 + $18,300). The tax increases by $4,059 of the increased $18,300 of non-SS income, a phantom-but-very-real 22.2% ($4,059 / $18,300) marginal tax rate.

Note there was zero tax on the first $13,000 of non-SS income and the 22.2% bracket began at $19,500 of non-SS income. The real marginal tax rate increased from zero to 22.2% over a $6,500 ($19,500 - $13,000) span of income![7]

This is where the phantom marginal tax rate gets gruesome. With $37,800 of non-SS income plus $35,000 gross Social Security benefits, the hapless retiree enters the 22% advertised marginal tax bracket. Social Security is still being phased into the taxable base, up to the point at which 85% of the $35,000, or $29,750 of SS, is subjected to tax. Getting there from $37,800 requires an additional $8,400 of non-SS income. Add $8,400 to the $37,800 and an additional $7,140 of SS is taxed. Tax is paid on $15,540 ($8,400 + $7,140), even though the actual income increased by only $8,400 (from $37,800 to $46,300). That $15,540 is taxed at 22% (the advertised marginal tax bracket), which equals (rounded) $3,420 of tax, which is 40.7% ($3,420 / $8,400) of the $8,400 of increased non-SS income.

Our unsuspecting retiree is still in the 22% bracket and the real tax bracket drops from 40.7% back to 22% because, at $46,300 of non-SS income, 85% of the SS has been added to the taxable base. The following table shows this single retiree's hidden tax rates at various non-SS ordinary income levels.

Real Tax Rates at Various Income Levels for a Single Filer with $35,000 Gross Social Security for 2023

Increase in Non-SS Income	Total Non-SS Income	Taxable Social Security	Adjusted Gross Income	Tax Increases by	Total Tax	Advertised Marginal Bracket	Math (Tax/ Increased Real Income	Hidden Tax Bracket
$13,000	$13,000	$2,750	$15,750	N/A	$6	10%		0%
$4,000	$17,000	$4,925	$21,925	$617	$623	10%	617/4,000	15.43%
$2,500	$19,500	$7,050	$26,550	$465	$1,088	10%	465/2,500	18.6%
$18,300	$37,800	$22,605	$60,405	$4,059	$5,147	12%	4,059/18,300	22.18%
$8,400	$46,300	$29,745	$75,945	$3,410	$8,557	22%	3,410/8,400	40.7%
Actual Increase	Above $46,300	$29,745	Actual Increase	22% of Increase		22%		(Not Hidden)

The role of inflation in exacerbating high marginal tax rates, even on those with modest incomes

Using 2023 rates, the maximum gross SS a single filer can generally earn while avoiding the hidden 40.7% marginal bracket is a mere $23,000 (about $60,000 for joint filers). Twenty years ago, that was a lot of SS. As recently as 2006, our clients' average (not including those who worked largely in government jobs, which makes them mostly ineligible for SS) was in the $15,000 range for a combination of single and joint filers. The maximum SS received by a single client was $28,000, and $37,500 for a joint filer (few spouses at that point were earning maximum SS because few had 35 high-income years). By 2012, those maximums hit $32,000 for one single filer and $47,000 for one joint filer. For 2022, before the massive 8.7% increase for 2023, our average was in the $25,000 to $30,000 range; the maximum for a single filer for 2022 was $47,000. This was nearly 50% higher than the highest SS in 2012, despite the fact that reported 2012 through 2022 inflation was 28%. Our highest earning joint filers received $93,000, nearly 100% more than the highest earning couple in 2012. (Both spouses earned near-maximum wages subject to SS during their entire working careers).

The nationwide average full-year Social Security income in 1985 was a seemingly minuscule $6,000, the equivalent of nearly $18,000 today. In 2000 the average reached a tad over $10,000, and more than $14,000 in 2010. By 2023 it hit nearly $20,400. The average Social Security recipient, which includes many government worker retirees with limited SS income, avoids the atrocious 40.7% hidden marginal bracket. But that could be temporary, depending on inflation adjustments to Social Security benefits, marginal tax rate bracket adjustments, and the standard deduction. (For 2023, the standard deduction yields zero tax on the first $15,700 of taxable income for single filers over age 64, which requires only $13,000 in non-SS income for a SS recipient receiving $23,000, for whom $2,700 of SS is already phased in to the taxable base!)

Balancing optimal Social Security income with pre-tax retirement savings

Permanent SS income increases by roughly 7% for every year the start of Social Security is delayed. Therefore, should you live long enough, the longer the delay the higher the lifetime Social Security income. Yet, the higher the SS, the larger the "chunk" of income taxed at exorbitant marginal tax rates. Should you delay the start of Social Security or, to keep SS lower, start early? Optimizing this decision is impossible, as there are too many variables and unknowns that whiplash you in either direction.

Social Security is subject to inflation adjustments. You might start with only $23,000 of Social Security, which currently cannot be subjected to the 40.7% phantom rate. But due to cost-of-living increases, you might eventually find yourself subject to that rate. When a spouse dies, with large enough non-SS income the Social Security a survivor can earn without being taxed at the hidden 40.7% marginal rate may drop from $60,000 to $23,000. You could inherit a sizeable estate or come into some other windfall, which may increase investment income in your later years. Or, the government could decide to tax 100% of Social Security.

On the other hand, Congress could recognize its grotesque error (which I don't believe was an oversight by the 1984 and 1994 Congresses) and adjust the income levels at which SS begins to get phased into the taxable base, or even revert to pre-1984 rules (one can dream). You could run out of savings at age 90 and live to 100. There might be a market collapse, which could reduce the value of both pre-tax and non-retirement plan accounts. You might suffer a costly disaster, which could greatly reduce non-retirement savings and, therefore, investment income. A tax-qualified uninsured disaster could yield a huge tax deduction that results in low or negative taxable income, which might allow a huge pre-tax retirement plan withdrawal or Roth conversion at zero and low tax rates. If there is little left in pre-tax plans, there is little to convert—which is a waste of zero and low tax rates. Those spending their last months or years in a nursing home, with huge medical deductions, can take much larger pre-tax withdrawals and conversions at zero and low tax rates. (Our only "failures" in doing Roth conversions at low brackets involve clients who had little left in pre-tax accounts, who ended up in nursing homes with enormous qualifying medical deductions for several years with little offsetting income, thereby "wasting" deductions at zero and low brackets.) People become destitute for a variety of reasons, with only Social Security to rely on. And this, from someone who understands the risks to Social Security itself (and who, for that matter, does not even believe in the current system).

The fact that so many are getting hit at substantially higher tax rates than even a decade or two ago changes the calculations for breaking even by delaying the start of SS. Without taking into account taxes created due to SS, if you live to age 82 you were generally better off delaying the start of SS to age 66; if you live to age 89, you were generally better off delaying the start to age 70. The possibility of higher marginal tax rates due to being the recipient of large SS benefits changes these ages: perhaps SS should be started at age 64-65 for those who expect to live to age 82, and age 68 for those with a life expectancy of 89 (age 70 for those who think they will live to age 91).

The key decision is whether contributions should be redirected to Roth IRAs and Roth 401(k)s, and/or conversions be made from traditional IRAs, 401(k)s and other pre-tax retirement plans to Roth IRAs and Roth 401 (k)s. We have seen that tax rates for many will be higher in retirement than nearly everyone thought possible. Therefore, many more taxpayers would likely benefit in the long run by switching at least a part of their contributions to Roth-style plans and doing more and bigger Roth conversions. This is especially true for married couples before the death of a spouse.

Most taxpayers with pre-tax plan balances of more than $500,000 ($300,000 to $400,000 for single filers) are converting less than they should. Those who can convert at tax rates lower than those expected in retire-

ment should convert. This is especially important for joint filers because, after a spouse dies, tax rates, the standard deduction and Medicare Premium Surcharges get cut nearly in half for the surviving spouse. Many taxpayers who expect income of $20,000 to $30,000 or more non-pre-tax retirement plan income, who also expect substantial income from Social Security, should convert much of what they have in such plans. Conversions can save tens of thousands of dollars of tax in the long run when done prior to collecting Social Security. The opportunity to do Roth conversions at relatively low tax rates may still be an excellent reason to delay the start of SS; this, despite the fact that the resulting larger SS income will create high phantom rates on a larger "chunk" of income.

Unique workarounds for uncommon "retirees"

Working retirees in or near the point at which 85% of SS is taxed can reduce income and save up to 40.7% on a chunk of income they contribute to 401(k)s, IRAs or self-employed retirement plans. Those who itemize deductions (most commonly those with large charitable donations and/or hefty out-of-pocket medical bills) are hit with hidden marginal tax rates at higher income levels.[8]

The amount of income that self-employed individuals, active partners in partnerships, and S corporation shareholders can earn without hitting the higher hidden rates is greater to the extent they are able to deduct health premiums and, for the self-employed and active partners, half of the self-employment tax. The self-employed, S corporation owners, partners in partnerships, and rental property owners with net income also can earn more income at lower marginal tax rates before reaching the 22.2% and 40.7% hidden rates to the extent eligible for the Qualified Business Income Deduction (QBID).[9]

We can see there are no perfect solutions, fixes or remedies to a problem created by a Congress in which—ironically—most of the politicians are dead. The problem worsened over the decades with inflation which, even at 2% per annum compounded, greatly increased the number of affected retirees. Because inflation took hold in 1913, when the Federal Reserve Act partially eliminated the stable price system under the Gold Standard, and which was turbo-charged in 1971 when the Gold Standard completely ended, short of the elimination of the tax on Social Security a perfect solution does not exist. At the very least, I hope this has informed you about the history and mechanics of the taxation of Social Security benefits. At best, I hope it helps you mitigate the problem by taking full advantage of relatively low marginal tax rates before a spouse dies and/or before starting Social Security by shifting retirement assets from pre-tax to Roth plans.

1. Tax rates are divided into ranges of income that determine the rate applied to each bracket or chunk of income. The marginal tax rate is the percentage tax rate paid on the last (highest) chunk (dollar amount) of income. What many refer to as the effective tax rate is the average rate paid on all of a taxpayer's income. The marginal rate is crucial for decisions because the marginal rate, not the effective rate, determines the additional cost or savings from receiving additional income or taking additional deductions.

2. J.M. Keynes, "Money DOS: an operating system for financial survival," 80-Microcomputing Magazine, August 1982

3. See https://www.northwesternmutual.com/life-and-money/your-401k-when-it-was-invented-and-why/ for a fascinating history.

4. It can be higher than 40.7% in two specific circumstances: when there are itemized medical expenses and qualifying dividends and/or long-term capital gains. Itemizers may experience a 1.5% increase in marginal tax rates due to the 7.5% "hair-cut" for medical deductions as income increases. Those with qualifying dividends and/or long-term capital gains, taxed at zero for taxpayers in the advertised 10% and 12% brackets, are subject to an additional 5% marginal rate once they enter the advertised 22% bracket. This "pay-back" provision is intended to "make up" for the zero capital gains rate while in the advertised 10% and 12% ordinary income brackets. The result can be a real rate as high as 47.2% for those whose SS is being phased into the taxable base, though nominally in the 22% bracket. When there are both medical phase-outs and qualifying investment income, rates can reach 51.6%. For working retirees, these rates do not even count FICA tax on wages or self-employment tax on self-employment income. Nor does it include state income tax.

5. This will no longer be true with another doubling of the Consumer Price Index, when Social Security alone could subject retirees with the highest "benefits" to tax, absent any inflation adjustment to the phase in. Currently, those recipients receiving maximum SS begin to pay tax when non-SS income reaches about $9,000.

6. A change to the law in 2020 created an additional incentive to avoid building large pre-tax accounts. Before the change, a million dollar pre-tax inherited IRA could be withdrawn over the lifetime of the beneficiary(ies), often 40 years or more depending on IRS life expectancy tables (this was known as the "stretch IRA"). Therefore, a beneficiary with a 40-year life expectancy could start with a year-one Required Minimum Distribution (RMD) of $25,000 from a $1 million IRA and continue taking incrementally increasing amounts over the following 39 years. Since 2020, the entire million-dollar inherited IRA must be withdrawn by most non-spouse beneficiaries over ten years, with RMDs if they were required for the decedent. Beneficiaries are, therefore, much more likely to land in higher marginal tax brackets with inherited pre-tax retirement accounts under the post-2019 regime.

7. Compare this span of income with the advertised tax brackets for 2023: single filers are taxed on the first $11,000 of taxable income at 10% and the next $33,726 at 12%, the two shortest brackets for any filing status.

8. Sizable itemized deductions increase the income one can earn at lower tax brackets in the same way that a larger standard deduction does.

9. A joint filer's $73,000 of fully taxable retirement plan income resulted in a 40.7% marginal bracket once SS exceeded $60,000. If that same $73,000 was net rental income, which allows a QBID, the amount of SS could increase by nearly $13,000 before triggering a 40.7% marginal tax rate.

FAQs: Extension and Estimate Payments

Extensions and estimated tax payments are confusing to most clients. When filing an extension, you are usually paying not only last year's tax liability, but also the first (and sometimes second) quarterly estimated taxes we expect for the current year. Here are the most frequently asked questions we get from clients regarding extension and estimate payments. We hope this clears up any confusion you've had regarding extensions and estimate payments.

What is an extension? The IRS allows taxpayers to request an extension for filing their federal tax return if they cannot file by the April 15 deadline. It does NOT extend the time to pay any tax due. If you do not pay the full amount of federal taxes owed by April 15, a .5% monthly penalty, plus interest, currently at 8% per annum (.667% per month), immediately begin accruing.

Why do you have us pay so much with the extension? Not only is the balance of last year's tax due on April 15, but also the first quarterly estimate for the current year. The 2nd quarterly estimate for the current year is due two months later, June 15. We encourage clients to pay both 1st and 2nd quarterly estimates with the extension payment to avoid potential current year underpayment of estimated tax penalties, now running at 8% per annum.

Why can't I pay in two separate checks, one with the extension and another as an estimate? Because the penalty for underpaying last year's tax liability is more than the penalty for underpaying the current year's estimated tax. The penalty for underpaying last year's tax is now 1.167% per month; the penalty for underpaying this year's estimates is currently .67% per month. That amounts to 14% per annum vs. 8% per annum.

If you or we inadvertently underestimate the balance due for last year, the extra amount we have you pay with the extension makes up the shortfall for last year's liability first; any excess gets applied to the current year's estimated taxes. If you write separate checks for extensions and estimates, we cannot apply the estimates to the prior year tax balance due.

How does paying last year's tax with estimates for this year in one check get applied to this year's estimates? By requesting on the tax return that this be done. We apply the excess of tax paid over last year's tax liability to the current year. That is why we have you pay both the extension and estimate payments in **one check**.

Let's look at an example: Say we think your prior year tax liability will be $14,000 and you had $4,000 of withholding. The extension requires a $10,000 payment for the prior year.

We usually base current year estimates on last year's tax liability minus expected withholding. Therefore, we would expect you to also owe $10,000 in quarterly estimates for the current year, or $2,500 per quarter.

The extension we send you will include the $10,000 you owe for last year plus $5,000 for the first two current-year quarters, or $15,000 total. If your prior-year tax liability is exactly as forecast, we apply the additional $5,000 paid to the current year tax liability.

But if you end up owing more than expected, for example $2,000 more, rather than applying $10,000 of your $15,000 extension payment to the prior year, we will apply $12,000 of the $15,000 extension to the prior year, and apply only $3,000 to the current year. We will have you make up the $2,000 shortfall with the 2nd quarterly estimate. This way, you can avoid late-payment penalties. If we don't know your prior year tax liability by June, we will have you "catch up" later; in the meantime, we succeeded in reducing your prior year underpayment penalty.

In other words, if we are short on last year's tax, we want estimates made for the current year to be applied to the prior year—because the penalties are MUCH higher for not paying prior year tax by April 15 than underpaying current year estimates. This also explains why we have clients pay in one check rather than two separate checks.

How should I keep track of my estimate payments? We recommend you fill in the "Record of Estimated Tax Payments" page we include behind the cover letter of the prior year's tax return. Not only does it summarize what you owe and when, but also shows how much overpayment we applied from a prior year and provides the detail required to complete the subsequent year's tax return, as we need to know which entity was paid, exact dollar amount and date for each and every payment. Check number is optional.

Can I pay online? Yes, you can pay both your extension and estimated payments online. In fact, we now recommend it and will no longer send envelopes for prior-year tax payment vouchers and current-year estimated tax vouchers beginning in 2025 unless requested. Be sure to double check the period you are filing for and the form you are filing before making your payments. Print a copy of the confirmation receipt and check your bank account a few days later to ensure the payment goes through.

Can I make all estimated payments at once? Yes, you can set up one payment with the full dollar amount you wish to pay. With current interest rates on money you keep in your own accounts, we generally do not recommend paying everything in advance. However, if you are concerned about forgetting to pay or if the amounts are relatively small, this could work for you.

Alternatively, you can set up a series of payments with future dates up to a year in advance, all in one online session. Be sure to note on your calendar when the funds will be drawn from your account because the IRS and states do not remind you when the funds will be drawn, and they charge a bundle for overdrafts.

Can I pay online with a credit card? Yes, but we recommend against doing so because not only do you pay a 3-4% fee to the credit card company for the privilege of making the payment, but also you may end up paying huge credit card interest if not paid off within the credit card billing cycle. The 1.167% per month interest/penalty costs alluded to above for non-payment of tax due may be cheaper than paying by credit card.

Do I need to register or set up an account with the IRS and state(s) to make payments online? Usually not. The IRS and California do not require you to register to make payments. Other states vary. Colorado, for example, requires you to register to make "free" payments, or they charge a nominal $1 fee per payment to pay tax without

registering.

When are estimated tax payments normally due? For federal and most states, 25% of the expected tax liability for the current year is due on the following dates: April 15, June 15, September 15 and January 15 of the following year. But not California!

Why is California different? Thirty percent of the expected tax liability is due by April 15, 40% (total = 70%) by June 15, with the balance due (the remaining 30%) by January 15 of the following year. As we have long written on our cover letter that includes any estimates: "If you are paying CA estimates, you may wonder why there are only three 'quarterlies,' front-loaded. The answer, 'how CA tried to balance its books on the backs of productive entrepreneurs and investors via accounting legerdemain,' can be found on pp. 4-5 of issue # 38 of the client letter at www.DougThorburn.com."

New Reporting Requirements for All Small Corporations and LLC's (including LLC's taxed as Partnerships and Single Member LLC's)

By Kristin Ericson, EA

Starting January 1, 2024, all small businesses that filed set-up paperwork with their Secretary of State must report certain business and "beneficial ownership" information to the Financial Crimes Unit of the US Treasury Department. **Beneficial Owners** include those with a 25% or greater interest in the business, ***and*** "key personnel," including senior officers and "important decision makers," which include individuals that directly or indirectly exercise "substantial" control over the business. Such key personnel make important business, financial, structural, leadership, operational and other such decisions for the business, and are not necessarily owners. The government wants to know who owns *and* controls the business.

Existing businesses have until the end of 2024 to supply all required information. New businesses formed during 2024 have 90 days after business formation to provide all required information. New businesses formed after December 31, 2024 will have only 30 days.

Each business must provide information on the business, including its name, physical address, Tax ID number, and the state where it was formed. The full legal name of each Beneficial Owner must be provided, plus date of birth and actual home address (not a PO Box). The document number and jurisdiction of issuer of an unexpired Driver's License, Passport, or State ID must be given, and a legible copy of that document must be uploaded to their system.

The initial report needs to be filed only once. However, when there is a change to any business information, a change of beneficial owners, or a change to a beneficial owners' information, it must be amended. An amended report must be filed within 30 days of the change.

New businesses formed after December 31, 2023 must also report the full information of "the individual who files the documents that creates, directs and controls the initial filing of the formation documents with the Secretary of State." The name, address, date of birth, document number and jurisdiction of issuer of an unexpired Driver's License, Passport, or State ID must be provided. A legible copy of that document must be uploaded. Absurdly, if this "Company Applicant" is also a "Beneficial Owner," the ID documents you will upload to their system must have different names—even though you are uploading the same document. Just give one a slightly different name and you're good.

Many businesses are not required to file. These include: 1) Schedule C sole proprietorships, Schedule F farms and Schedule E rentals that are not Limited Liability Companies—LLC's, or Single Member LLCs—SMLLC's (yet another reason to avoid setting up an LLC); 2) Businesses with more than 20 employees and gross incomes of at least $5 million dollars; 3) Tax-exempt organizations formed under Internal Revenue Code Section 501(c) (however, since exempt status is not granted within 30 days of formation, new exempt organizations must file the report, and then file a retraction once granted exempt status); and 4) Businesses in certain industries that already provide such information to the government, including banks and credit unions

Aside from a few tax-exempt businesses, all of our clients that are C-Corporations, S-Corporations, LLC's taxed as Partnerships, LLC's taxed as S- or C-Corporations, and LLC's (SMLLC's) filing Schedule C, Schedule E or Schedule F on their personal returns must file the report. Schedule C, E or F businesses that are *not* SMLLCs—businesses that are not registered with the Secretary of State office—do not need to file this report.

We have learned from other tax professionals and our insurance carrier that the determination of which companies are required to file the report and which individuals are deemed to be "Beneficial Owners" are legal questions. Answering these questions is, therefore, considered "the practice of law." We are not lawyers, we are not entitled to practice law and, therefore, we are not allowed to make these determinations for you, unfair though that may be. See Section D starting on page 9 of the BOI FAQ's on the FinCEN's BOI website for further details on who a Beneficial Owner could be (along with a slew of additional questions and answers covering everything about the report). Nor are we allowed to prepare the reports for you, but general instructions follow below. If you still need assistance, we can recommend an attorney to assist you.

The good news is once you've determined you need to file and who must be reported as "beneficial owners," it is a fairly easy fill-in-the-blank series of 3-4 pages (or more depending

on the number of beneficial owners).

The question we initially had is why is the government requiring this? The US Treasury Department says it will help crack down on illicit businesses by identifying companies that launder money, aid or commit terrorism, commit fraud and other crimes. When real owners can no longer hide behind shell companies, they will be easier to find and prosecute. However, we wonder if this will help government exert more control over small businesses and whether the information will be misused *.

In addition, the government is taking this entire enterprise *very* seriously. The civil penalties for failure to provide the required information by the specified deadline(s) is $500 *per day*; the criminal penalties max out at $10,000 and 2 years in prison *per incident!* We suspect many legitimate business owners do not know about this and will not learn of it on time.

How to complete the report

We offer the following with the hope it will help reduce your frustration. Once you have figured out who the beneficial owners are obtain from each a legible copy of their unexpired Driver's License, Passport, or State ID and get their physical home address. Be mindful of the fact that passports do not contain addresses, and Driver's Licenses or State IDs may report a business address, a PO Box, or be out of date. Save the document as a .jpg, .png or .pdf file. The name of the saved file cannot have spaces or special characters.

Next, go to the main reporting website at https://boiefiling.fincen.gov/fileboir and select the PDF version of the application (open the link and select "Prepare BOIR" in the "File PDF BOIR" section). The PDF version allows you to save as you progress and informs you of any errors. The non-PDF online version allows for neither of those options and if there is an error you will have to start over—without telling you what the error is. Depending on your web browser, some of the drop-down menus may not work; we suggest saving the document to your computer and filling in the saved downloaded version using Adobe (free version available on the BOIR website). Read through the instructions *carefully* as you go through each page of the report. Also read the documents on the FinCEN website describing the meaning of "Beneficial Owner"—it's essential to determine who is an "owner" or has "substantial control" over your business. Generally, "owners" are individuals with a 25% or more ownership interest in the business, while those with "substantial control" are individuals—owners and non-owners—capable of making or allowed to make "important" decisions on behalf of the business. Those with "substantial control" could be non-owner officers, directors, other employees or even spouses.

This will be an initial report for most of you. Once you check the "initial report" box on page 1, you will not need to fill out lines 1e-h (which covers what was shown on a prior report). The name of your business ("Reporting Company") on page 2 must match the name as filed with the Secretary of State. Most of you will have a company Federal Employer's ID Number (EIN or FEIN), but those of you with SMLLC's may need to use your Social Security number. Report the physical address of the business. The "Jurisdiction of formation or first registration" is the state in which you formed the business.

On the "Company Applicant Information" page, if your business existed before January 1, 2024, check the box on line 16 stating that was so, which allows you to bypass page 3. New businesses will need to complete page 3. The "Company Applicant" is the individual who filed the formation paperwork with the Secretary of State.

On the last page, fill in the first Beneficial Owner's information, matching the name and date of birth from the unexpired Driver's License, State ID or Passport ("document") you will upload. Use the current physical home address. Add additional beneficial owners by checking the Plus (+) box in the top right corner of the page and scroll down to page 5 for the next person, then to page 6, etc. And because you must update the report every time the document used is renewed for each beneficial owner, we suggest using the document with the longest time to renewal.

Individuals that are beneficial owners of multiple companies can streamline the process and avoid sending each company their personal information by applying for a 12-digit "Beneficial Owner FinCEN ID." The Reporting Company enters the 12-digit number at the top of the page, rather than filling in the name, address, date of birth and document information, and having to upload the document. If an individual beneficial owner's information changes, the beneficial owner can make the change without (we think) each Reporting Company having to file an amended report. You can create a FinCEN ID on the main website.

Once all information is input and double-checked, click "Save" (save it where you can easily find it) and then "Validate return" on page 1. Fix any errors that pop up. Print the report, "Finalize" it, return to the website, and file it with FinCEN by clicking "Submit BOIR" in the "File PDF BOIR" section. Fill in your e-mail and the company information, and we think they will notify you when it is approved.

When the company has any change, including to its name, beneficial owners or primary physical address or to a beneficial owner's name, primary physical address or Driver's License, Passport or State ID (which includes renewals), the initial report must be modified. Since you have saved the report (somewhere you can easily find it!), you can make the changes to the old report and save it as a new file, eliminating the need to re-input all the information. Save it as an "Update prior report" form and submit it online within 30 days of the change.

* Doug adds: This appears to be yet another intrusion into our privacy. The information might be misused, but we haven't figured out how. We are mindful that the Patriot Act made similar promises. We have tentatively concluded that the argument that the government will be able to go after shell companies committing bad acts "seems" to make sense. We'll see.