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LAGOS
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BUILDING, PROTECTING AND PERPETUATING FAMILY WEALTH

ADVISOR'S BULLETIN

WHAT'S IN THIS MONTH'S NEWSLETTER

The Advisor's Bulletin is provided by Lagos Wealth Advisors and Lagos Financial & Insurance Services, Inc. It is intended to serve as a resource for the advisors which we are associated with. Recent developments in estate, business, and insurance planning are outlined for your reference. Should you wish to receive additional information related to financial planning, estate planning, insurance planning, or investment management, please do

WHAT EVERY FINANCIAL PROFESSIONAL NEEDS TO KNOW ABOUT FEDERAL INCOME TAX WITHHOLDING

A MESSAGE FROM MICHAEL W. LAGOS, CFP®

It's no secret that the federal government has been spending more than it has been collecting in taxes. That's one of the reasons the folks at the IRS are interested in making sure every one of its citizens pays a fair share of income taxes.

The IRS has two important tools to help it collect the correct amount of income tax from taxpayers:

1. The federal income tax return. Individual taxpayers are obligated to file an income tax return every year if their income is above a certain threshold. The filers must report their taxable income and figure out their tax liability. If tax deposits made during the year are not adequate to cover the tax bill, taxpayers have to write a check for the difference. The federal government has the infrastructure in place to punish those who fail to do this as required.
2. The system for withholding estimated federal income taxes. The IRS collects estimated tax deposits from taxpayers during the year from various sources, including:

   - payroll deduction
   - mandatory withholding from certain kinds of distributions
   - voluntary withholding
   - quarterly tax deposits

The taxes that are withheld or otherwise deposited during the year are almost never equal to the taxpayer's actual income tax liability. That's one of the goals of the federal income tax return—for the taxpayer to reconcile the difference between the tax deposits and actual tax liability. A taxpayer who has deposited too much with the IRS during the year gets a tax refund. Another who has sent in too little must write a check for the shortfall.

What are the rules on federal income tax withholding? Why do tax withholding rules exist? How should our clients effectively use the rules when doing tax planning? Read on for the answers to these questions.

Regards,
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WHAT EVERY FINANCIAL PROFESSIONAL NEEDS TO KNOW ABOUT FEDERAL INCOME TAX WITHHOLDING

FEDERAL INCOME TAX WITHHOLDING

The federal government has implemented a system for collecting income taxes from its citizens that relies on a mix of voluntary and mandatory techniques. The most obvious required tool is the obligation for most taxpayers to file a federal income tax return. Failure to file can subject a citizen to significant civil and criminal penalties.

The tax withholding portion of the system mixes mandatory and voluntary processes.

The Objectives of the System

The main overall objective of the withholding system is to estimate the amount of tax due in connection with certain taxable events and collect an appropriate amount at the source of the income. The taxpayer won't be sure the amount withheld is correct until she files an income tax return and reconciles tax deposits with actual tax liability.

Withholding is a tool in the federal government's arsenal to ensure income tax compliance. In 2019, the federal government is projected to collect total personal income taxes of $1.824 trillion, roughly 50 percent of the total revenues of the United States. See https://www.thebalance.com/current-u-s-federal-government-tax-revenue-3305762.

According to the most recent statistics, the voluntary tax compliance rate is 81.7 percent. After accounting for enforcement and late payments, the net compliance rate is 83.7 percent (https://www.irs.gov/newsroom/the-tax-gap). Without withholding, more taxpayers would likely try to avoid federal income taxes entirely or pay less in taxes than they actually owe.

Mandatory Withholding

Some types of tax withholding are mandatory; the taxpayer has no choice about how much is withheld. Other types, such as income tax withholding in connection with payroll, are quasi-mandatory. Withholding is quasi-mandatory in that the taxpayer has some ability to influence how much is deducted for federal income taxes.

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Employers are responsible for taking deductions from employees' paychecks and sending required amounts to the federal government. Some deductions are earmarked for Social Security-related taxes, and others are a pre-payment of federal income taxes. We will focus on the income tax portion.

Employer Responsibility

Employers must report income and employment taxes withheld from their employees on an Employer's Quarterly Federal Tax Return (Form 941) and deposit these taxes in full to an authorized bank or financial institution pursuant to Federal Tax Deposit Requirements.

Employers who do not comply with the employment tax laws may be subject to criminal and civil sanctions for willfully failing to pay employment taxes.

The rate at which the employer makes deductions from an employee's pay is based on information an employee provides on Form W-4.

The IRS's withholding tables can be found in Publication 15.

Employee Responsibility

The employee is responsible for accurately providing the necessary information on Form W-4 so that the employer makes federal income tax deductions at the proper rate. The goal is for the aggregate annual tax deposits made in connection with payroll to roughly equal the employee's income tax liability for the year.

By the way, if the employer does not properly withhold and submit taxes from wages and the IRS is unable to collect the employment taxes from the employer, the employee still has the responsibility to pay the income tax due.

There is a $500 civil penalty if an employee knowingly submits a Form W-4 which results in less tax being withheld than is required.

New Rates Based on TCJA

In 2018, the IRS issued new withholding rates based on the tax changes that were part of the Tax Cut and Jobs Act (TCJA). The changes in withholding allowed employers to make adjustments to the deductions for income taxes made from an employee's paycheck—even if the employee had not filled out a new Form W-4 for 2018 or 2019.

Having said that, it is still a best practice for an employee to fill out and submit a new Form W-4 every year so that the withholding amount closely matches the employee's actual federal income tax liability.

The IRS also provides an online W-4 calculator tool that can help an employee fill out a physical Form W-4. The calculation can be found here: https://apps.irs.gov/app/withholdingcalculator.

Qualified Plan Distributions

Many qualified plan participants are surprised when the funds they receive from a requested distribution are reduced for mandatory federal income tax withholding.

> Distributions from eligible retirement plans (other than IRAs), such as qualified plans, 401(k) plans, section 457(b) plans maintained by a governmental employer, section 403(a) annuity plans or section 403(b) tax-sheltered annuities that are eligible to be rolled over tax free to an IRA or another eligible retirement plan, are subject to a flat 20% withholding rate. The 20% withholding rate is required and a recipient can't choose to have less federal income tax withheld from eligible rollover distributions.
>
> https://www.irs.gov/publications/p15a

The mandatory withholding of 20 percent applies to distributions from employer plans when the distributions are paid to the taxpayer, even if the taxpayer intends to roll the distribution into an IRA or another plan later. If the taxpayer wishes to defer taxes on the amount withheld, she will need to replace the withheld funds with funds from another source.

Because of the mandatory 20 percent withholding, it may be beneficial for the taxpayer to have the funds transferred directly to the new carrier when the option is available. If the direct rollover procedure is used, there is no mandatory tax withholding.

Amounts not eligible for rollover—such as RMDs—are not subject to mandatory withholding.

Nonresident Aliens

U.S. income tax rules are hard to understand. Tax complexity increases greatly where noncitizens are involved. In general, both the U.S. and the person's native country will want to collect taxes on income. To further cloud matters, our government has tax treaties with many other countries, which may work to determine which country actually collects the tax it thinks is due.

The best advice for someone who is a foreign national is to seek out a CPA familiar with the tax rules in both countries—and is also familiar with any tax treaty provisions—to help answer tough question.

Additional interesting questions arise when the person who owes U.S. income tax is a nonresident alien. Such a person may simply decide not to file a U.S. income tax return in an attempt to avoid paying income taxes—relying on the likelihood that the federal government may not be able to force them to file or pay.

To address that potential issue, the IRS has special withholding rules that apply to nonresident aliens.

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If a nonresident alien is employed by a U.S. taxpayer, special payroll withholding is required:

> Salaries, wages, bonuses, or any other pay for personal services (referred to collectively as wages) paid to nonresident alien employees are subject to graduated withholding in the same way as for U.S. citizens and residents if the wages are effectively connected with the conduct of a U.S. trade or business.
>
> Note. Any wages paid to a nonresident alien for personal services performed as an employee for an employer are generally not subject to the 30% withholding if the wages are subject to graduated withholding.
>
> https://www.irs.gov/publications/p515#en_US_2019_publink1000224978

The nonresident alien also has to follow special rules in connection with completing Form W-4.

> A nonresident alien subject to wage withholding must give the employer a completed Form W-4 to enable the employer to figure how much income tax to withhold. . . .
>
> In completing Form W-4, nonresident aliens should use the following instructions instead of the instructions on Form W-4.
>
> - Check "Single" on line 3 (regardless of actual marital status).
> - Claim only one withholding allowance on line 5. If you are a resident of Canada, Mexico, South Korea, or India, see Notice 1392.
> - Write "Nonresident Alien" or "NRA" above the dotted line on line 6.

https://www.irs.gov/publications/p515#en_US_2019_publink1000224965

Depending on the country from which the nonresident alien comes, the employer may be obligated to withhold an additional amount from wages over the normal deduction for a single taxpayer with one allowance.

OTHER TAXABLE INCOME

Where a nonresident alien generates taxable U.S.-based income, the federal government also imposes special withholding rules at the source of the income.

> In the absence of a treaty exemption, nonresident aliens, nonresident alien beneficiaries, and foreign estates generally are subject to a 30% withholding tax under section 1441 on the taxable portion of a periodic or nonperiodic pension or annuity payment that is from U.S. sources.
>
> https://www.irs.gov/publications/p515#en_US_2019_publink1000224965

No TIN

A person does not need to be a nonresident alien to fall off the tax paying grid. Those who have no Social Security numbers may become partly invisible to the IRS. The Service uses tax ID numbers to cross-reference taxable income, helping to ensure tax compliance.

What happens if a taxpayer has no tax ID? According to IRS Tax Topic 307:

> You must withhold 24% (backup withholding rate) from a reportable payment made to a U.S. person that is subject to Form 1099 reporting if any of the following apply.
>
> - The U.S. person has not provided its taxpayer identification number (TIN) in the manner required.
> - The IRS notifies you that the TIN furnished by the payee is incorrect.

Voluntary Withholding

Just because federal income tax withholding may not be required, in some cases it may be advisable for a client to elect voluntary withholding.

For example, say that Bridgette, age 60, is taking a $100,000 taxable distribution from her IRA in 2019. She expects that to be her only taxable income for the year. Doing some rough math, she believes her federal income tax liability for the year will be about $15,000.

While Bridgette is not obligated to have the IRA custodian withhold federal income taxes from the distribution, she decides to have 15 percent sent to the IRS on her behalf from the distribution.

By taking strategic advantages of voluntary withholding, some taxpayers may be able to avoid the hassle of making quarterly estimated tax deposits.

Quarterly Deposits

Taxpayers can send in quarterly estimated tax deposits to the IRS using Form 1040-ES. Estimated tax is the method used to prepay federal income tax on income that isn't subject to withholding, such as earnings from self-employment, interest, dividends, rents, or alimony. A taxpayer should also make estimated tax payments on other taxable income, such as unemployment compensation and the taxable part of your Social Security benefits.

Individuals generally have to make estimated tax payments if they expect to owe tax of $1,000 or more when their return is filed. The IRS requires a taxpayer to responsibly estimate the year's taxes and to make commensurate quarterly deposits, if required.

> When figuring your estimated tax for the current year, it may be helpful to use your income, deductions, and credits for the prior year as a starting point. Use your prior year's federal tax return as a guide. You can use the worksheet in Form 1040-ES (PDF) to figure your estimated tax. You need to estimate the amount of income you expect to earn for the year. If you estimated your earnings too high, simply complete another Form 1040-ES worksheet to refigure your estimated tax for the next quarter. If you estimated your earnings too low, again complete another Form 1040-ES worksheet to recalculate your estimated tax for the next quarter. You want to estimate your income as accurately as you can to avoid penalties.
>
> You must make adjustments both for changes in your own situation and for recent changes in the tax law.
>
> https://www.irs.gov/businesses/small-businesses-self-employed/estimated-taxes

Managing Withholding

A recent *USA Today* story pointed out that tax refunds for 2018 were trending lower than for prior tax years:

> The average tax refund issued so far dropped to $1,949, down 8.7 percent from $2,135 at the same time last year, according to IRS statistics. Last week, the agency reported that refunds were off by 8.4 percent compared with 2018 after the first week of filing. See https://www.usatoday.com/story/money/2019/02/14/taxes-2019-why-my-refund-smaller-year/2870908002/.

Part of the implication of the story is that the TCJA changes were responsible for lower taxpayer refunds. The truth is that the tax changes may have played a role, but in most cases the taxpayers are mostly responsible for the size of any federal income tax refund.

As we've discussed in this article, refunds are the difference between the amounts a taxpayer prepays to the IRS and the actual income tax liability. Most taxpayers choose—consciously or not—how much they prepay. That choice dictates the size of the refund.

How can a taxpayer choose to prepay less in federal income tax?

- Adjust withholding in connection with wages by submitting an updated W-4 to the employer.
- Do not make voluntary withholding choices.
- Avoid mandatory withholding situations.

Penalty for Underwithholding

Where the taxpayer fails to send in enough money to prepay taxes during the year, the IRS imposes a penalty. The underpayment levy was recently made more favorable to taxpayers:

> The IRS is generally waiving the penalty for any taxpayer who paid at least 85 percent of their total tax liability during the year through federal income tax withholding, quarterly estimated tax payments or a combination of the two. The usual percentage threshold is 90 percent to avoid a penalty. See https://www.irs.gov/newsroom/irs-waives-penalty-for-many-whose-tax-withholding-and-estimated-tax-payments-fell-short-in-2018.

The penalty for underpayment varies. It is currently 4 percent per year.

CONCLUSION

Our clients rely on us to help them manage a variety of issues—income tax management included. In this tax filing and federal income tax paying season, we are likely to be asked more questions about taxes than we normally receive.

Even though in most cases we are not responsible for helping our clients file their tax returns, we can play a proactive role in helping them manage their projected tax liabilities and income tax withholding. We can help them avoid future unexpected IRS debts at the tax-filing deadline by helping them consider:

- rollovers from qualified plans or between IRAs,
- Section 1035 exchanges,
- income tax bracket management through strategic Roth conversions,
- sensible capital gains harvesting, perhaps in conjunction with capital losses, and
- controlled timing of taxable transactions.

We can also help them manage their tax withholding behaviors.

Clients who send the IRS too much money during the course of a year are essentially giving the federal government an interest-free loan. While that loan will be repaid when our clients file their tax returns for the year—in the form of a tax refund—not many people would consciously opt to give the Treasury Department a bargain loan.

Financial professionals should also help their clients make sure they are sending enough in tax deposits to our servants in Washington during the course of the year. By helping ensure the right amount of tax deposits, clients can avoid having to write a big IRS check at tax-filing time—and also the potential avoidable penalties associated with inadequate withholding.

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Building Protecting and Perpetuating Family Wealth

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