Pomegranate Financial

Refresh & Simplify
Your Financial Life

Newsletter

Volume II Issue 8 | August 2023

The Basics of Taxes

We are breaking down taxes this month as we get closer to 'tax planning season.' Generally I consider the months from October to December tax planning season. Knowing this information might help you do a bit of your own tax planning.

Let's start off with FICA which stands for Federal Contributions Insurance Act. I actually never knew it stood for that until writing this newsletter because everyone refers to it as FICA, social security and Medicare tax, payroll tax, or self-employment tax.

Yes, the same type of tax has at least four different names:
FICA, Self-employment, payroll, and social security and Medicare tax.

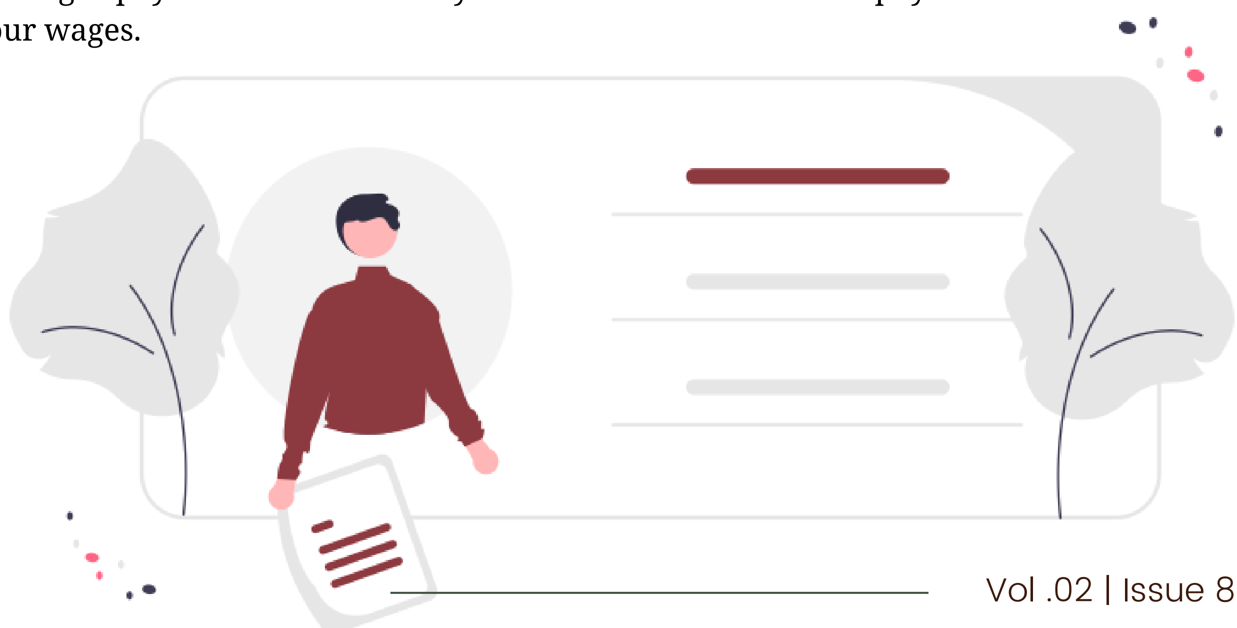
That tax is 15.3%! But half of it is paid by the employee and half is paid by the employer. So if you look at your paystub right now you'll see that 7.65% was withheld from your paycheck to pay taxes into social security and Medicare. Your employer paid the other 7.65%. If you own your own business then you end up paying the entire 15.3%, though you could get a small tax break with that!

We break that tax down even further:

- The social security portion is 6.2%
- The Medicare portion is 1.45%.

That's important to know because there is an income limit on the social security tax and no limit on the Medicare tax.

For 2023 the social security income limit is $160,200. That means once you have earned more than $160,200 then you no longer pay the 6.2% tax on any additional income. You do pay taxes on the Medicare no matter how high your wages.



You can go online and create an account at www.ssa.gov to see your wages (based on paying into social security) since you started working. I would highly recommend doing so. It's interesting to see how your income has changed over the years. It will also give you your estimated social security benefit for when you retire or if you became disabled.

Are there any discounts or tax deductions for FICA?

Not really, unless you own an S-Corp. If you own a business and it is taxed as an S-Corp entity then you probably hold different roles within your business. In addition to your main role, these roles might include marketing, sales, administration, quality control, compliance, etc. The IRS says you need to pay yourself reasonable compensation.

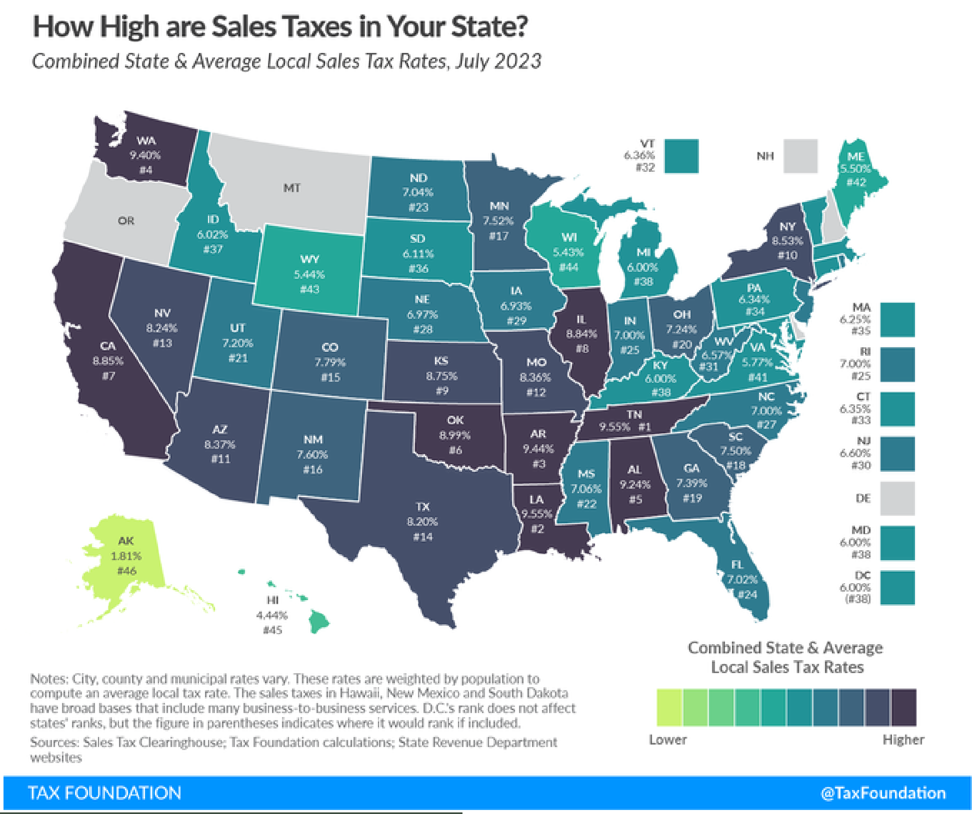
Reasonable compensation essentially means you pay yourself a competitive wage for the role(s)/type of work you provide and therefore you pay into social security & Medicare with that wage. Paying FICA taxes is not cheap so this naturally incentivizes owners to pay themselves a lower 'wage' in order to pay less in FICA taxes. They don't pay FICA taxes on the rest of their business profit. Business owners have to be careful though because if they don't pay themselves a reasonable wage according to the IRS terms, then the IRS can make them pay interest, penalties, and taxes on what their reasonable compensation should have been.

The important point is that unless you are a business owner, then you pay FICA tax (7.65% employee portion) on your salary. Other types of income such as investments, real estate, business, etc. is not subject to that tax.

Sales Tax:

Every state, county, and city can vary with sales tax. You are paying sales tax when you make most of your purchases (there are a few select states without sales tax). It's something to factor in when thinking about moving.

One way to pay less in sales tax is typically when purchasing used items (yard sales, KSL classifieds, etc.). Another possible way is at flea/farmer markets. To lower your sales tax you would need to evaluate your monthly spending and look for alternatives (gas vs electric, grocery store vs farmer market, used items vs new, etc.).



Income tax (2023 chart):

The United States has a tiered income tax system. The easiest way to understand it is by looking at a chart.

FEDERAL INCOME TAX

TAX RATE	MFJ	SINGLE
10%	$0 - $22,000	$0 - $11,000
12%	$22,001 - $89,450	$11,001 - $44,725
22%	$89,451 - $190,750	$44,726 - $95,375
24%	$190,751 - $364,200	$95,376 - $182,100
32%	$364,201 - $462,500	$182,101 - $231,250
35%	$462,501 - $693,750	$231,251 - $578,125
37%	Over $693,750	Over $578,125

The first $22k of taxable income for a married couple (MFJ) is taxed at 10% (after their standard/itemized deduction). The next $67,449 is taxed at 12% ($89,450 - $22,001), and so on until all their taxable income has been calculated. It is a pretty straightforward calculation until you throw in the deductions and credits such as retirement contributions, health savings contributions, child tax credit, dependent care credit, etc.

The simplest income tax calculation would be a single individual with no children, who rents, makes no tax deductible contributions and receives no tax credits. Each additional variable be it children, businesses, spouse, contributions, mortgage interest, charitable contributions, and other credits may have zero impact to a large impact on your income tax.

Capital Gains Tax:

Short-term gains are taxed as ordinary income. That means you held an investment for less than one year before you sold it. That investment gain is just added to your taxable income and factored into the tax bracket system above.

Long-Term gains are taxed at bracketed rates as well. You'll see that if you had $40k of taxable income in 2023 (filing single) then you could have a gain of $4,625 that is not taxed federally!

LONG-TERM CAPITAL GAINS TAX

Rates apply to LTCGs and qualified dividends, and are based on taxable income.

FILING STATUS	0% RATE	15% RATE	20% RATE
MFJ	≤ $89,250	$89,251 - $553,850	> $553,850
SINGLE	≤ $44,625	$44,626 - $492,300	> $492,300

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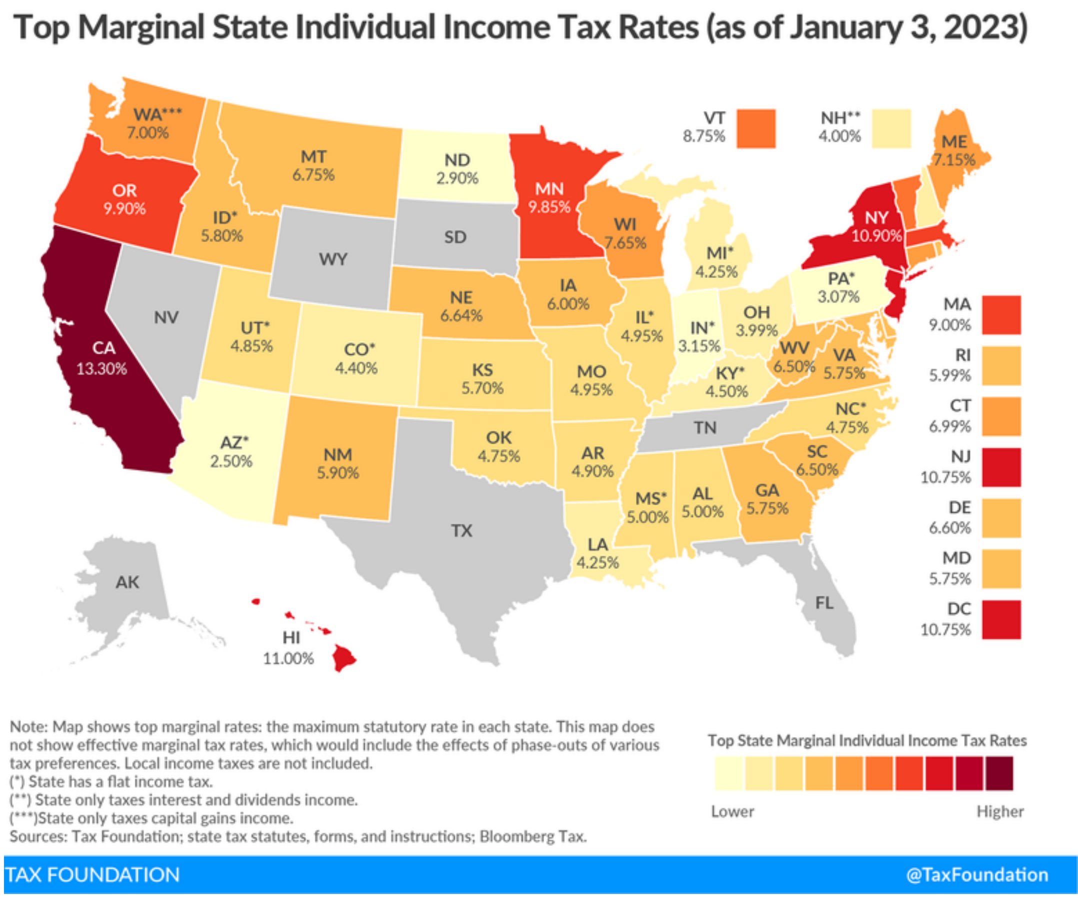
State Income Tax

State income tax varies. You'll find the chart shows the top marginal tax rate. That's because some states have no income tax, other's have a flat tax like Utah (now it is 4.5%), and other's like California have a tiered tax system.

Some states allow more tax deductions and credits while others allow fewer. Some states might not have any income tax like Texas, but tax you higher in other ways like property taxes.



In Summary:

We did not cover many other types of taxes like property, net investment income, and alternative minimum taxes.

Taxes really add up. They are typically one of your biggest expenses without knowing it. FICA, federal, and state income tax comes out before receiving your paycheck. Sales tax is added onto your bill at the store. Property taxes are usually lumped in with your mortgage payment. A lot more people would be more proactive about saving on taxes if they had to pay their taxes monthly by going online.

To finish, here's a sample household in the US:

Single with one child (HoH) who rents with an income of $75k.

- FICA: $5,738
- Federal Income: ~$4,802
- State Income: ~$1,838
- Sales Tax: ~$1,200

Total: $13,578 or 18% of their income.

Blake Jones, CFP®, EA
PomegranateFinancial.com
blake@pomegranatefinancial.com