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LAGOS WEALTH ADVISORS
BUILDING, PROTECTING AND PERPETUATING FAMILY WEALTH

ADVISOR'S BULLETIN

WHAT'S IN THIS MONTH'S NEWSLETTER

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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

A MESSAGE FROM MICHAEL W. LAGOS, CFP®

Dear Strategic Advisor:

Five years ago we wrote about federal income tax withholding. 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 that every one of its citizens pays a fair share of income taxes.

State income taxation works in much the same way as the federal system. Where it gets interesting is that each state has its own rules about income taxes. State income taxation on individuals—and the withholding associated with it—has the potential to cause significant confusion for our clients.

Some states impose relatively high taxes on income earned by residents. Idaho, for example, imposes a flat state income tax rate of 5.8 percent. At the other end of the tax spectrum, a few states (Florida, for instance) impose no state income tax at all.

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 both federal and state income tax returns—for the taxpayer to reconcile the difference between the tax deposits and actual tax liability. A taxpayer who has deposited too much 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 state income taxes and associated tax withholding? Why do tax withholding rules exist? How should our clients effectively use the rules when doing tax planning? Read on for help in answering these questions.

Please feel free to contact me to discuss further.

Regards,
Michael W. Lagos, CFP®

What Every Financial Professional Needs To Know About State Income Taxes And Withholding

STATE INCOME TAXES

Each state government selects its own method of imposing (or not) state income tax.

We have also summarized each state's approach to income taxation in the appendix to this article.

State Income Tax Variations

Some states impose no income tax at all. Others collect a flat tax, while still others mimic the federal government's graduated income tax.

In general, states that impose an income tax use the information from the taxpayer's federal tax return to calculate the correct liability.

NO TAX

As of the date of this newsletter, the following states impose no state income tax.

Alaska	**Florida**	**Nevada**
South Dakota	**Tennessee**	**Texas**
	Wyoming	

FLAT TAX

A significant minority of states impose a flat tax. The key characteristic of the flat tax is that the marginal income tax rate is the same—no matter how much or how little taxable income the resident has.

We mentioned earlier that Idaho imposes a flat income tax rate of 5.8 percent. As with federal rates, the tax is imposed on the resident's taxable income.

Taxable income for most states that impose an income tax is generally calculated in a different manner from federal income tax. While the state calculation of taxable income generally starts at the same number as federal gross income, the adjustments from that point often can differ greatly.

For example, while the federal government might allow the owner of a proprietorship to claim a pass-through business deduction, the same adjustment to income is not necessarily available at the state level.

GRADUATED TAX

The majority of states impose a graduated income tax. In general, that means the more income a resident makes, the higher the tax bracket—up to the state maximum.

California has a graduated income tax structure. For a married couple filing jointly, the rates start at 1 percent and rise to 12.3 percent. See the chart below:

If the amount on Form 540, line 19 is over –	but not over –	Enter on Form 540, line 31			of the amount over –
$ 0	$ 20,824	$ 0.00	+	1.00%	$ 0
20,824	49,368	208.24	+	2.00%	20,824
49,368	77,918	779.12	+	4.00%	49,368
77,918	108,162	1,921.12	+	6.00%	77,918
108,162	136,700	3,735.76	+	8.00%	108,162
136,700	698,274	6,018.80	+	9.30%	136,700
698,274	837,922	58,245.18	+	10.30%	698,274
837,922	1,396,542	72,628.92	+	11.30%	837,922
1,396,542	AND OVER	135,752.98	+	12.30%	1,396,542

SELECTIVE TAX

To make matters even more confusing, some states treat certain kinds of income differently from others.

For example, New Hampshire taxes only interest and dividends—not wages or capital gains. Washington taxes capital gains only.

Many states have provisions that exclude pensions and other retirement income from taxation. In other states, though, only certain kinds of retirement income are tax-free.

A few states tax federal Social Security benefits. Some treat capital gains in the same way as ordinary income while others (Montana, for example) give some preferential treatment to gains.

State Income Tax Withholding

State governments have implemented their own systems for collecting income taxes from their citizens that rely on a mix of voluntary and mandatory techniques.

THE OBJECTIVES OF THE SYSTEM

The main overall objective of the withholding systems—federal or state—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.

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.

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.

The mandatory withholding of 20 percent on 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 taxpayers wish to defer taxes on the amount withheld, they 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, but the taxpayer may choose to have federal withholding apply.

Often, a particular state's approach to withholding is tied to what the federal government does. For example, Delaware requires withholding at a 5 percent rate when federal withholding occurs. A taxpayer has the ability to elect not to have Delaware tax withheld—except when the federal withholding is connected to an eligible rollover distribution from a qualified plan.

California, in contrast, provides for state withholding when federal withholding applies but gives the taxpayer the ability to opt out even for an eligible rollover distribution.

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 2024. 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. Our clients need to pay attention to how voluntarily electing federal withholding might affect state income tax withholding and make tax choices accordingly.

For example, Iowa requires 5 percent state income tax withholding when federal tax is withheld. It makes no difference if the federal withholding is mandatory or voluntary.

THE CHART

Are the rules surrounding state income tax withholding confusing? You bet! To help readers have a handy general reference for state income tax rules we have included a chart in the appendix to this newsletter.

We believe the chart information accurately summarizes the current state income tax and withholding rules that apply to taxable distributions from IRAs, qualified plans, life insurance and annuities. However, we have a few warnings readers should consider:

- Things can change in a heartbeat. State income tax and withholding rules and rates often shift with little or no warning.
- State withholding rules aren't always as clear as they could be. While we have taken pains to provide information that is as accurate as possible, state taxing authorities do not always spell out their rules in reliable detail.
- Carriers and financial institutions don't all agree on current withholding rules. In part because some state rules are ambiguous, our clients may experience situations where state tax withholding is different from that indicated in the chart.
- Carriers and financial institutions sometimes make practical decisions to limit a taxpayer's withholding choice. For example, in some states where withholding is optional, the company may refuse to honor a taxpayer's request for state income tax withholding.

With those qualifiers, we hope readers will find the information in the chart helpful as clients sort out their decisions regarding distributions and tax withholding.

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 debts at the state income 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,
- Differences between state and federal tax approaches to certain income,
- 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 their states too much money during the course of a year are essentially giving the governments 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 a bargain loan to their state representatives.

Financial professionals should also help their clients make sure that they are sending enough in tax deposits during the course of the year. By helping ensure the right amount of tax deposits, clients can avoid having to write big checks at tax-filing time.

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IN THIS ISSUE OF ADVISOR'S BULLETIN

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State Income Taxes And Withholding

Building Protecting and Perpetuating Family Wealth

LWA strives to develop and maintain sound financial plans designed to achieve our client's wealth accumulation, preservation and transfer objectives, with the goal of preserving their wealth for multiple generations. We provide these services in a confidential and consultative manner, building life-long relationships based upon education, trust, communication and service.

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