


Year End Planning - Minding the \$13,000 Tax Gap [One of My Oh Shit Moments]

The GYFG blog recently picked up a new reader (Sean), who finally asked the question I have been waiting for all summer. It was around how my taxes were so low on such a high income. It's a good thing we have smart readers that ask good questions (someone has to keep me honest). It makes for nice opportunities to continue to provide full transparency. On other blogs I see many commentators get ignored when a question like this is asked.

Not here!!! Not us!!!

See his original comment below:

 Sean
1 approved

Submitted on 2015/10/19 at 9:25 am
Sorry for back tracking here but I just found your site. Curious how you have over 32k in income but pay less than 5k in taxes, especially here in California. Me and my fiance make about 20k a month in income but pay about 8k in taxes..any help how you keep it so low would be much appreciated!!

July 2015 - Detailed Financial Report
#7 - Net Worth \$232,728 (+28.3% YTD)
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Although I was prepared to answer this question as taxes have been on my mind a lot lately, but I kept putting off finally building accurate tax calculations into my spreadsheet. I had been using the back of the napkin rate I calculated at the beginning of the year when I thought our income was going to drop in 2015 to about \$180K (vs. \$214K in 2014). So, without thinking anything of it I replied the following:

Gen Y Finance Guy
634 approved

Submitted on 2015/10/19 at 9:46 am | In reply to Sean.

Hey Sean - That is a fantastic question, and one I am very surprised most have not asked yet. I have been waiting for it all year.

There are a lot of things going on here (some things specific to the month):

- 1 - In July we did receive a gift of \$5,000 (non taxable)
 - 2 - The \$2,000 in rental income we receive does not have any taxes being taken out (at least until we file)
 - 3 - We contributed \$2,200 to tax deferred retirement accounts.
 - 4 - We contributed \$500 to and HSA which is exempt of federal, state, and FICA taxes (bonus of 7.1% savings)
 - 5 - My wife and I had a combined \$3,000 in 1099 income (again it won't be taxed until we file, we will probably have to look into doing quarterly estimates)
 - 6 - Some of the money that my wife "earns" is actually a reimbursement of business expenses (this month that didn't happen).
 - 7 - I have also not factored in credit card float that has an effect on cash flow, which also distorts the picture. I called this out in the September report, and will fix it going forward in October.
 - 8 - The last piece is that we adjust our withholding on our W-4 based on what we estimate our tax bill to be based on our deductions (mortgage interest, depreciation on rental, carry forward market losses, property taxes, Business expenses, etc.). Based on this planning I have my deductions set to 10 with my wife at 1.
- So if you make those adjustments to come up with taxable income you are looking at \$19K of taxable income (vs. \$32K reported gross income). This gives us an effective tax rate of 26% for the month.

I should also point out that we are also planning for a tax credit for installing solar this year. A post is in the Que to be published sometime in the next couple of weeks.

I will also point out that our income has increased substantially this year and I expect I will have to cut a check to the IRS again. There is even a chance that we will be hit with a penalty. We never get money back from the IRS.

Taxes can become a pretty complicated thing to share with everyone. You will notice that I actually have gotten rid of the section on taxes going forward because of this. I don't want to be in the business of giving tax advice.

Thanks for the question and for keeping me honest. I am working through a way to provide even more transparency around this as we head into 2016.

Cheers!

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YTD]

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All of these points were valid and in alignment with my policy of full transparency. But then my alarm bells started going off when I was getting close to finishing my comment.

Notice the sentence about 2/3's down the comment above where I say **"I will also point out that our income has increased substantially this year and I expect I will have to cut a check to the IRS again. There is even a chance that we will be hit with a penalty. We never get money back from the IRS."** The good news is that we will not be hit with a penalty after all (but more on that below).

It was that particular reply that forced me to realize that I had not re-calculated my new tax liability for 2015 based on the extra income from my promotion and the additional income that my wife had been earning as she has been growing her business (and she has been killing it). Typically, the way I like to pay taxes in the current year is to pay as little as possible, and then back load the end of the year, that way we get to hold onto the money as long as possible.

If you read my [September financial report](#) (in the contributions section) you will note that I did call out the fact that taxes did go up as I reduced my withholding's from 10 down to 2. But again this was based on the old plan (definitely a blonde moment and huge oversight on my part). Oh, and by the way I have black hair, so figure that one out ☐

New Tax Calculations Indicate a \$13,000 Gap

I immediately went to work finally building out a tax module in my spreadsheet to be able to calculate the following taxes:

1. Federal Income Tax (Tiered tax bracket, see below)
2. State Income Tax (Tiered tax bracket, see below)
3. Medicare (1.45% on all income and increase by 0.9% for high earners, see Vawt's link in comment below)
4. Social Security (6.2% on income up to \$118,000 per tax payer)
5. CA SUI/SDI (0.9% up to a max of \$7,000 per tax payer)

		Federal	Federal	Federal	Federal	Federal	Federal	Federal
		18,150	73,801	148,851	226,851	405,101	457,601	∞
Amount		10%	15%	25%	28%	33%	35%	40%
Taxable Income	149,501	18,150	55,651	75,050	650	-	-	-
Taxes	29,107	1,815	8,348	18,763	182	-	-	-
Federal Tax Rate	19.5%							

		State	State	State	State	State	State	State	State	State
		7,582	17,977	28,372	39,985	49,775	254,251	305,101	508,501	∞
Amount		1%	2%	4%	6%	8%	9%	10%	11%	12%
Taxable Income	149,501	7,582	10,395	10,395	11,613	9,790	99,726	-	-	-
Taxes	11,454	76	208	416	697	783	9,275	-	-	-
State Tax Rate	7.7%									

Although our total projected income for 2015 is \$248K, our taxable income is around \$150K after all tax deferred contributions and our estimated deductions. After building in detailed tax calculations into my spreadsheet, here is what I came up with:

GYFG P&L - 2016 FCST	Actual	Actual	Actual	Actual	Actual	Actual	Actual	Actual	Actual	Forecast	Forecast	Forecast	Forecast	
	Jan-15	Feb-15	Mar-15	Apr-15	May-15	Jun-15	Jul-15	Aug-15	Sep-15	Oct-15	Nov-15	Dec-15	2015	
Gross Pay	\$25,083	\$15,711	\$15,057	\$15,509	\$16,194	\$19,423	\$32,651	\$20,370	\$28,069	\$22,515	\$21,865	\$16,365	248,812	
Pre Tax Contributions														
401K Deduction	\$2,540	\$1,215	\$1,169	\$1,169	\$1,169	\$1,169	\$1,649	\$1,446	\$3,138	\$1,058	\$1,058	\$1,058	\$17,838	
IRA For Wife	\$5,500	\$500	\$500	\$500	\$500	\$500	\$500	\$500	\$500	\$500	\$500	\$500	\$11,000	
HSA Account	\$0	\$0	\$0	\$46	\$46	\$46	\$500	\$1,000	\$1,000	\$1,000	\$1,000	\$1,000	\$5,638	
Health/Dental Ins.	\$649	\$433	\$433	\$387	\$387	\$387	\$580	\$387	\$387	\$387	\$387	\$387	\$5,188	
Total Pre-Tax	\$8,689	\$2,148	\$2,102	\$2,102	\$2,102	\$2,102	\$3,229	\$3,333	\$5,025	\$2,944	\$2,944	\$2,944	\$39,664	
Take Home Pay (BEFORE TAXES)	\$16,394	\$13,563	\$12,955	\$13,407	\$14,092	\$17,321	\$29,422	\$17,037	\$23,044	\$19,571	\$18,921	\$13,421	\$209,148	
Taxable Income (AGI)	\$17,686	\$8,672	\$5,930	\$5,939	\$8,234	\$10,808	\$19,606	\$11,644	\$18,545	\$16,413	\$15,763	\$10,263	\$149,501	
Federal Taxes	3,443	1,688	1,155	1,156	1,603	2,104	3,817	2,267	3,611	3,195	3,069	1,998	29,107	
State Taxes	1,355	664	454	455	631	828	1,502	892	1,421	1,257	1,208	786	11,454	
Medicare	166	295	168	171	164	178	207	349	222	368	292	212	2,793	
Social Security	708	1,262	719	732	701	763	887	1,492	951	1,572	1,247	906	11,941	
CA SUI/SDI	103	183	104	106	102	111	129	217	138	228	181	132	1,733	
Federal Tax Credit													(4,505)	
Health Savings Account (FICA Reduction)													(444)	
Taxes	\$5,775	\$4,094	\$2,600	\$2,621	\$3,201	\$3,985	\$6,543	\$5,216	\$6,343	\$6,621	\$5,996	(915)	\$52,080	
<i>% of Taxable Income</i>	33%	47%	44%	44%	39%	37%	33%	45%	34%	40%	38%	-9%	35%	
Effective Tax Rate	23%	26%	17%	17%	20%	21%	20%	26%	23%	29%	27%	-6%	21%	
													Previous Calc	\$39,162
													Gap	(\$12,918)

You will notice that I have layered in a tax credit of \$4,505 that we will be realizing

in the 2015 tax year for going Solar (there is a post coming on this soon). I also layered in the FICA (Medicare and Social Security) savings for contributions made to our HSA.

WE HAVE A \$13,000 TAX GAP!!!

Side Note: I had to take a few tums to relieve the heart burn after realizing we will our tax liability for 2015 was \$52,080 (that's how much I made during my first year out of college). Imagine what you could do with an extra \$52,080...even worse, imagine how the government is going to waste that money. But such is life and it's the PRICE WE PAY to live in this AWESOME USA.

Since making these calculations I went into our ADP portal and changed my personal deductions to **ZERO** and told ADP to add an additional \$1,000 per pay period in additional tax payments. This should close the gap by \$5,000 (give or take), **but still leaves us with an \$8,000 check to write to Uncle Sam** come **APRIL 15TH OF 2016**.

As much as I hate writing a check to Uncle Sam, I like holding onto my money as long as possible. This move will ensure we don't get hit with any penalties for underpayment.

Generally, most taxpayers will avoid this penalty if they either owe less than \$1,000 in tax after subtracting their withholding and estimated tax payments, or if they paid at least 90% of the tax for the current year or 100% of the tax shown on the return for the prior year, whichever is smaller. - [IRS website](#)

Summary

The good news is that I won't be caught off guard on this again next year. My master spreadsheet now has the tax model built into it, to allow me to keep close tabs on what our tax liability is going to be. The timing was good, because I had just started to take a first pass at forecasting 2016, so that we could start setting our goals.

Taxes are never fun, but I always remind people that taxes are a good problem to have. It means you are making money.

Learn from my blonde moment and make sure you stay on top of your taxes, especially when you start making huge financial strides in your income.

-Gen Y Finance Guy



Gen Y Finance Guy

Hey, I'm Dom - the man behind the cartoon. You'll notice that I sign off as "Gen Y Finance Guy" on all my posts, due to the fact that I write this blog anonymously (at least for now). I like to think of myself as the *Chief Freedom Officer* here of my little corner of the internet. In the real world, I'm a 30-something former C-Suite executive turned entrepreneur turned capital allocator. I am trying to humanize finance by sharing my own journey to Financial Freedom. I believe in total *honesty* and *transparency*. That is why before I ever started blogging, I decided that I would share all of my own [financial stats](#). I do this not to brag, but instead to inspire motivate, and also to hold myself accountable. My goal is to be a beacon of hope, motivation, and inspiration for *you*, the reader, by living life by example and sharing it **all** here on the blog. My sincere hope is that you will be able to learn from me - both from my successes and my failures! [Read More](#)