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Newsletter August 2024

Dear clients:

As the beginning of fall is just around the corner, so too are some important extended filing deadlines. Calendar year-end Partnership and S Corporation returns are due September 15th, fiduciary returns are due September 30th, and individual and C Corporation returns are due October 15th. In order to prepare your returns, we must receive your complete tax information one month prior to these deadlines (e.g. complete information for individual returns must be received no later than September 15th). If your complete information is not received one month prior to the deadline, we cannot guarantee the returns will be timely filed by the extended deadline. When sending us your information, electronic copies are always preferred. If you forward us paper documents, please take care that you are sending us a copy of the documents and retaining the original copy for your records. If you have questions, please contact our office.

Aaron Bagby
Kramer, Jensen & Bagby, LLC

Get Those Kids a Job: The Tax Advantages of Securing Summer Jobs for Your Children

Article Highlights:

- Standard Deduction
- IRA Options
- Self-Employed Parent
- Employing Your Child
- Tax Benefits

Children who are dependents of their parents are subject to what is commonly referred to as the kiddie tax. This generally applies to children under the age of 19 and full-time students over the age of 18 and under the age of 24.

The kiddie tax originated many years ago as a means to close a tax loophole where parents would put their investments under their child's name and social security number so that their investment income would be taxed at lower tax rates. Enter the kiddie tax, under which unearned income (investment income) more than a minimum amount is taxed at the parent's highest marginal tax rate.

Tax-Free Income - On the bright side, a child's earned income (income from working) is taxed at single rates, and the standard deduction for singles is $14,600 for 2024. This means that your child can make $14,600 from working and pay no income tax (but will be subject to Social Security and Medicare payroll taxes), and if the child is willing to contribute to a traditional IRA, for which the 2024 contribution cap is $7,000, the child can make $21,600

from working—federal income tax free.

Even if your child is reluctant to give up any of their hard-earned money from their summer or regular employment, if you, a grandparent, or others have the financial resources, the amount of an IRA contribution could be gifted to the child, giving your child a great start toward their retirement savings and hopefully a continuing incentive to save for their retirement.

Employing Your Child – If you are self-employed (an unincorporated business), a reasonable salary paid to your child reduces your self-employment (SE) income and your income tax by shifting income to the child.

For 2024, when a child under the age of 19 or a student under the age of 24 is claimed as a dependent of the parents, the child is generally subject to the kiddie tax rules if their investment income is upward of $2,600. Under these rules, the child's investment income is taxed at the same rate as the parent's top marginal rate using a lower $1,300 standard deduction. However, earned income (income from working) is taxed at the child's marginal rate, and the earned income is reduced by the lesser of the earned income plus $400 or the regular standard deduction for the year, which is $14,600. If a child has no other income, the child could be paid $14,600 and incur no income tax. If the child is paid more, the next $11,600 he or she earns is taxed at 10%.

- ***Example:*** *You are in the 22% tax bracket and own an unincorporated business. You hire your child (who has no investment income) and pay the child $16,500 for the year. You reduce your income by $16,500, which saves you $3,630 of income tax (22% of $16,500), and your child has a taxable income of $1,900 ($16,500 less the $14,600 standard deduction) on which the tax is $190 (10% of $1,900). The net income tax saved by the family is $3,440 ($3,630 - $190).*

If the business is unincorporated and the wages are paid to a child under age 18, he or she will not be subject to FICA – Social Security and Hospital Insurance (HI, aka Medicare) – taxes since employment for FICA tax purposes doesn't include services performed by a child under the age of 18 while employed by a parent. Thus, the child will not be required to pay the employee's share of the FICA taxes, and the business won't have to pay its half either. In addition, by paying the child and thus reducing the business's net income, the parent's self-employment tax payable on net self-employment income is also reduced.

- ***Example****: Using the same circumstances as the example from above, and assuming your business profits are $180,000, by paying your child $16,500, you not only reduce your self-employment income for income tax purposes, but you also reduce your self-employment tax (HI portion) by $442 (2.9% of $16,500 times the SE factor of 92.35%). But if your net profits for the year were less than the maximum SE income ($168,600 for 2024) that is subject to Social Security tax, then the savings would include the 12.4% Social Security portion, $1,889 (12.4% of $16,500 x 92.35%), in addition to the 2.9% HI portion for a total savings of $2,331 ($442 + $1,889).*

A similar but more liberal exemption applies for FUTA, which exempts from federal unemployment tax the earnings paid to a child under age 21 while employed by their parent. The FICA and FUTA exemptions also apply if a child is employed by a partnership consisting solely of the child's parents. However, the exemptions do not apply to businesses that are incorporated or a partnership that includes non-parent partners. Even so, there's no extra cost to your business if you're paying a child for work that you would pay someone else to do anyway.

Retirement Plan Savings - Additional savings are possible if the child is paid more and deposits the extra earnings into a traditional IRA. For 2024, the child can make a tax-deductible contribution of up to $7,000 to his or her own IRA. The business also may be able to provide the child with retirement plan benefits, depending on the type of plan it uses and its terms, the child's age, and the number of hours worked. By combining the standard deduction of $14,600 and the maximum deductible IRA contribution of $7,000 for 2024, a child could earn $21,600 of wages and pay no income tax.

- *However, referring back to our original example, the child's tax to be saved by making a $7,000 traditional IRA contribution is only $190, so it might be appropriate to make a Roth IRA contribution instead, especially since the child has so many years before*

retirement and the future tax-free retirement benefits will far outweigh the current $190 savings.

If you have questions about the information provided here and other possible tax benefits or issues related to hiring your child, please give this office a call.

A Guide to Maximizing Tax Deductions for Small Business Owners

Article Highlights:

- Maximize Expenses
- New Businesses
- Legal and Professional Fees
- Spousal Joint Ventures
- Self-Employed Health Insurance
- Self-Employed (SE) Tax Deduction
- Insurance
- Home Office
- Qualified Business Income Deduction
- Advertising Expenses
- Website Costs
- Financing
- Vehicle Expenses
- Meal Deductions
- Entertainment
- Deducting the Cost of Business Supplies and Equipment
- Pension Plans
- Pension Start-Up Credit
- Employee Payroll
- Hiring Your Children
- Research Credit
- Accounting and Bookkeeping Fees
- Effects of TCJA Sunsetting After 2025

As a small business owner, one of your primary goals should be to maximize your business deductions to minimize your tax liability. Effective tax planning can significantly impact your bottom line, allowing you to reinvest more into your business. This comprehensive guide will cover various strategies and deductions available to small business owners, including those related to new businesses, legal and professional fees, spousal joint ventures, self-employed health insurance, home offices, business equipment, advertising expenses, website costs, financing, vehicle expenses, entertainment, depreciation, material and supply expensing, de minimis safe harbor expensing, routine maintenance, bonus depreciation, Section 179 expensing, business meals, the qualified business income deduction, and the effects of the Tax Cuts and Jobs Act (TCJA) sunsetting after 2025.

New Businesses - Starting a new business involves various costs, many of which can be deducted to reduce your taxable income. Normally, the costs of starting a business must be amortized (deducted ratably) over 15 years. However, you can elect to deduct up to $5,000 of start-up expenses and $5,000 of organizational expenses in the first year. Qualified start-up costs include:

- Surveys/analyses of potential markets, labor supply, products, transportation facilities, etc.
- Wages paid to employees, and their instructors, while they are being trained.
- Advertisements related to opening the business.
- Fees and salaries paid to consultants or others for professional services; and
- Travel and related costs to secure prospective customers, distributors and suppliers.

Each of the $5,000 amounts is reduced by the amount by which the total start-up expenses or organizational expenses exceeds $50,000. Expenses not deductible in the first year of the business must be amortized over 15 years.

Legal and Professional Fees - Legal and professional fees incurred in setting up your business fall under the organizational expense first year deduction of $5,000 and the balance would be amortized over 15 years. After your business is operational, these fees can be expensed as they are incurred. This includes costs for legal advice, accounting services, and consulting fees, which are essential for maintaining compliance and optimizing business operations.

Spousal Joint Ventures - For married couples running an unincorporated business together, it's common but incorrect to report all income as one spouse's sole proprietorship. Instead, you should consider a spousal joint venture, allowing both spouses to report income and expenses on separate Schedule C forms. This approach enables both spouses to accumulate Social Security benefits and contribute to retirement accounts.

In addition, to claim a childcare credit, both spouses on a joint return must have earned income (or imputed income if one of the spouses is a full-time student or is disabled), so unless the non-Schedule C spouse has another source of earned income, the couple would not be allowed a childcare credit. There are two ways to remedy this situation, either: (1) by establishing a partnership or (2) a joint venture (each spouse files a Schedule C with their share of the income, deductions, and credits).

Self-Employed (SE) Health Insurance – Rather than deducting health insurance as an itemized deduction medical expense subject to the 7.5% of AGI reduction, self-employed individuals can deduct 100% of health insurance premiums for themselves, their spouses, and dependents above the line, reducing your adjusted gross income (AGI) and potentially qualifying you for other tax benefits. However, this deduction is limited to the net income of the business. The deduction for SE health insurance is allowed even if the self-employed individual uses the standard deduction rather than itemizing deductions on Schedule A.

Self-Employment Tax Deduction – Sole proprietors with more than a minimal amount of profit from their business are required to pay self-employment tax (their contribution to the Social Security and Medicare programs, like the payroll taxes of employees). There is a deduction element to this tax. As a self-employed individual you may deduct 50% of your SE tax liability for the tax year. Like the self-employed health insurance deduction, the SE tax deduction is claimed as an above-the-line-deduction in computing adjusted gross income (AGI). You do not need to itemize deductions to claim the deduction.

Insurance - A range of insurance premiums are deductible for sole proprietors, if they are deemed necessary and ordinary for your business operations. This includes health insurance, liability insurance, property insurance, and auto insurance for vehicles used in your business.
Home Office - Small business owners may qualify for a home-office deduction, which will help them save money on their taxes and benefit their bottom line. Taxpayers can generally take this deduction if they use a portion of their home exclusively for their business and on a regular basis. Plus, this deduction is available to both homeowners and renters. There are two methods to determine the amount of a home-office deduction:

- *Actual-Expense Method* – The actual-expense method prorates home expenses based on the portion of the home that qualifies as a home office, which is generally based on square footage. Aside from prorated expenses, 100% of directly related costs, such as painting and repair expenses specific to the office, can be deducted. Unlike the simplified method, the business-use percentage for the calculation is not limited to 300 square feet.

- *Simplified Method* – The simplified method allows for a deduction equal to $5 per square foot of the home used for business, up to a maximum of 300 square feet, resulting in a maximum simplified deduction of $1,500.

A taxpayer may elect to take the simplified method or the actual-expense method (also referred to as the regular method) on an annual basis. Thus, a taxpayer may freely switch between the two methods each year. In addition, when using the simplified method, the taxpayer need not account for the home office depreciation when computing the gain when and if the home is sold.

Additional office expenses such as utilities, insurance, office maintenance, etc., are not

allowed when the simplified method is used. Prorated rent or home interest and taxes are not either, although 100% of home interest and taxes are deductible as non-business expenses if the taxpayer itemizes deductions.

Qualified Business Income Deduction - The TCJA introduced the Qualified Business Income (QBI) deduction, allowing eligible pass-through entities to deduct up to 20% of their qualified business income. This deduction is subject to various limitations and phase-outs based on income levels and business types. Proper planning is essential to maximize this valuable deduction.

Advertising Expenses - Once the business is operating, all forms of advertising are generally currently deductible expenses, including promotional materials such as business cards, digital or print advertisements, and other forms of advertising. However, any advertising expense incurred before a business begins functioning would be treated as a start-up expense. Trade shows are a form of advertising, and if a business purchases their own custom trade show booth, that booth can generally be totally or mostly expensed in the year purchased using bonus depreciation or Sec 179 expensing.

Website Costs - Website development and maintenance costs are deductible as business expenses. Initial development costs can be amortized over three years, while ongoing maintenance and updates can be expensed in the year incurred. A well-maintained website is crucial for attracting and retaining customers in the digital age.

Financing - Interest on business loans is deductible, reducing your taxable income. This includes interest on loans for purchasing equipment, real estate, or other business needs. Properly managing your business financing can optimize cash flow and support growth initiatives.

But be careful not to mix personal and business interest expenses. Banks are usually reluctant to lend money on a startup business. However, an equity loan on your home will generally achieve a lower interest rate anyway, and the interest can be traced to and deductible as business interest.

Vehicle Expenses - If you use your car for business purposes you can deduct its business use by using either the standard mileage method, which allows a per mile amount, or the actual expense method. However, both methods require that you track your business and total mileage for the year. If using the standard mileage method, you need to know the number of business miles driven, and if using the actual method, you will need to prorate the actual operating expenses including fuel, insurance, repairs, and depreciation by the percentage of business miles to total miles. You can also deduct tolls and parking fees with either method.

- *Record Keeping* - Both the standard mileage and the actual expense methods offer unique advantages and requirements, but one common thread is the necessity of meticulous record keeping. To claim the standard mileage rate, you must be able to substantiate the business use of your vehicle. This means keeping a detailed log of each trip, including the date, destination, purpose, and miles driven.

- *Business vs. Personal Use* - If you use your vehicle for both business and personal purposes, you must allocate expenses based on the percentage of business use. Accurate records of both business and personal mileage are essential to calculate this percentage correctly. In the event of an IRS audit, your mileage log serves as evidence to support your deduction claims. Without proper records, you risk having your deductions disallowed, which could result in additional taxes, penalties, and interest.

Meal Deductions - Meal expenses are deductible under certain conditions. These expenses must be ordinary and necessary for carrying on a trade or business, and not lavish or extravagant under the circumstances. However, the percentage of a qualified business meal that is deductible has varied in recent years.

- Prior to 2021 - Businesses were only allowed to deduct 50% of the cost of a qualified meal

- 2021 and 2022 - In response to the COVID-19 pandemic, the Consolidated

Appropriations Act, 2021, introduced a temporary provision allowing a 100% deduction for business meals provided by restaurants. The aim was to support the struggling restaurant industry by encouraging businesses to spend more on qualified meals.

- After 2022, the allowable deduction has reverted to 50% of the cost of a qualified meal.

Qualified meal deductions are basically in two categories, business meals and away from home meals:

- *Business Meals* - The taxpayer or an employee must be present at the meal. Additionally, the meal must be provided to a current or potential business customer, client, consultant, or similar business contact.

- *Away From Home Meals* - When there is travel away from home on business, the traveler may deduct 50% of the cost of their own meals. For instance, if a self-employed individual goes on a business trip and incurs meal expenses, they can deduct 50% of those costs. If they dine with a business contact, they can also deduct 50% of the cost of the contact's meal. The temporary 100% deduction for restaurant-provided meals in 2021 and 2022 also applied to away-from-home meals.

- Instead of actual meal costs, self-employed individuals can use an optional rate method, also called the standard meal allowance, in effect for the year, with the rate generally higher for major cities, resort areas and other locations in the U.S. The per diem rates for 2024 range from a low of $59 to $79. The applicable rates can be found at the following web site: **www.gsa.gov/perdiem**.

- *Recordkeeping and Compliance* - To claim business meal deductions, taxpayers must maintain detailed records. This includes keeping receipts, invoices, or other documentation that substantiates the expense. The IRS requires that the records clearly indicate the amount, date, location, and business purpose of the meal, as well as the identities of the individuals involved.

- **Entertainment** - The Tax Cuts & Jobs Act (TCJA) essentially eliminated the deduction for most entertainment expenses, but you can still deduct 50% of business meals if they are directly related to your business. This includes meals with clients, prospects, and employees. Proper documentation is essential to substantiate these deductions.

Away From Home Lodging Expenses - Self-employed individuals are not entitled to use the federal per diem rates to substantiate lodging expenses under any circumstances. There is no optional standard lodging amount like the standard meal allowance. The allowable lodging expense deduction is the taxpayer's actual cost as documented by receipts.

Deducting the Cost of Business Supplies and Equipment - From time to time, an owner of a small business will purchase equipment, office furnishings, vehicles, computer systems and other items for use in the business. How to deduct the cost for tax purposes is not always an easy decision because there are several options available, and the decision will depend upon whether a big deduction is needed for the acquisition year or more benefit can be obtained by deducting the expense over several years using depreciation. The following are the write-off options currently available.

- *Material & Supply Expensing* – IRS regulations allow certain materials and supplies that cost $200 or less, or that have a useful life of less than one year, to be expensed (deducted fully in one year) rather than depreciated. This simplifies accounting and provides immediate tax benefits for necessary business purchases.

- *De Minimis Safe Harbor Expensing* - The de minimis safe harbor rule allows businesses to expense purchases up to $2,500 per item or invoice, or $5,000 if the business has an applicable financial statement. This rule simplifies record-keeping and provides flexibility in managing smaller capital expenditures.

- *Routine Maintenance* – IRS regulations allow a deduction for expenditures used to keep a unit of property in operating condition where a business expects to perform the maintenance twice during the class life of the property. Class life is different than depreciable life. Here are examples of the class life and depreciable life differences for

some items commonly used in business:

Depreciable Item	Class Life	Depreciable Life
Office Furnishings	10	7
Information Systems	6	5
Computers	6	5
Autos & Taxis	3	5
Light Trucks	4	5
Heavy Trucks	6	5

- *Depreciation* – Depreciation is the normal accounting way of writing off business capital purchases by spreading the deduction of the cost over several years. The IRS regulations specify the number of years for the write-off based on established asset categories, and generally for small business purchases the categories include 3-, 5- or 7-year write-offs. The 5-year category includes autos, small trucks, computers, copiers, and certain technological and research equipment, while the 7-year category includes office fixtures, furniture and equipment. The cost of nonresidential real property (buildings) used in business is depreciated over 39 years.

- *Bonus Depreciation* – The tax code provides for a first-year bonus depreciation that allows a business to deduct 100% of the cost of most new or used tangible property if it is placed in service during 2022. This provides a larger first-year depreciation deduction for the item. Bonus depreciation is a temporary provision and for eligible business property bought after 2022, the rates drop to 80% in 2023, 60% in 2024, 40% in 2025, 20% in 2026 and nothing after 2026. When the bonus depreciation rate is less than 100%, the difference between the cost of the item and the bonus write-off amount is eligible for regular depreciation.

- *Sec 179 Expensing* – Another option provided by the tax code is an expensing provision for small businesses that allows a certain amount of the cost of tangible equipment purchases to be expensed in the year the property is first placed into business service. This tax provision is commonly referred to as Sec. 179 expensing, named after the tax code section that sanctions it. The expensing is limited to an annual inflation adjusted amount, which is $1,220,000 ($610,000 for taxpayers filing as married separate) for 2024. To ensure that this provision is limited to small businesses, whenever a business has purchases of property eligible for Sec 179 treatment that exceed the year's investment limit ($3,050,000 for 2024), the annual expensing allowance is reduced by one dollar for each dollar the investment limit is exceeded.

An undesirable consequence of using Sec. 179 expensing occurs when the item is disposed of before the end of its normal depreciable life. In that case, the difference between normal depreciation and the Sec. 179 deduction is recaptured and added to income in the year of disposition.

- *Mixing Bonus and Section 179 Expensing* - Businesses can combine bonus depreciation, regular depreciation, and Section 179 expensing to maximize deductions. This flexibility allows businesses to tailor their tax strategy to their specific needs, optimizing cash flow and tax savings.

- **Pension Plans** - Contributions to retirement plans, such as SEP IRAs or solo 401(k)s, are deductible. These plans allow for significant contributions, reducing taxable income while saving for retirement. For example, in 2024, the contribution limit for a SEP IRA is up to 25% of compensation (20% of the net business profit) or $69,000, whichever is less. If you have employees, your contributions to their retirement plans are deductible from your business income. However, your contributions to your own plan, while deductible from your adjusted gross income, are not an expense of your self-employment business.

- **Pension Start-Up Credit** - Where a small employer does not already have a pension plan, there is a tax credit for the costs of establishing a retirement plan, up to $500 per year per eligible employee for the first three years of the plan, maximum $5,000 per year. This can include setup and administrative costs.

- **Employee Payroll -** Wages paid to employees, including salaries, bonuses, commissions, and certain fringe benefits, are deductible business expenses. This encompasses all forms of compensation given to an employee for services performed, regardless of how the compensation is measured or paid. In addition. employers can also deduct the costs associated with payroll taxes. These taxes include the employer's share of Social Security and Medicare taxes, federal unemployment taxes (FUTA), and state unemployment taxes.

- **Hiring Your Children –** Where they can provide meaning services, hiring your children can be a smart move for both your business and your family. Not only does it provide your children with valuable work experience and instill a strong work ethic, but it also offers significant tax advantages. By employing your children, you can shift income from your higher tax bracket to their lower one, potentially reducing your taxable income and saving on taxes.

- **Research Credit -** The Research and Development (R&D) Tax Credit allows businesses to deduct expenses related to research and development activities. This can include wages, supplies, and contract research expenses. For a sole proprietor developing a new product, the costs associated with design, testing, and prototyping could be eligible for this credit.

- **Accountant and Bookkeeping Fees -** Including those related to tax preparation, payroll services, bookkeeping and other financial management activities, are generally deductible expenses for businesses. These costs are considered necessary and ordinary expenses incurred in the operation of a business.

It's important for business owners to maintain detailed records of these expenses to substantiate their deductions during tax filing. Consulting with a tax professional can provide further insights into how to maximize these deductions while adhering to the IRS guidelines.

Effects of TCJA Sunsetting After 2025 - Many provisions of the TCJA, including the QBI deduction and increased bonus depreciation, are set to expire after 2025. Business owners should be aware of these changes and plan accordingly. Strategies may include accelerating deductions and income recognition to take advantage of current tax benefits before they expire.

Maximizing business deductions requires careful planning and a thorough understanding of the tax code. By leveraging available deductions and credits, small business owners can significantly reduce their tax liability and reinvest savings into their business.
Please contact this office to ensure compliance with the latest tax laws and to tailor these strategies to your specific business situation. With the right approach, you can turn tax season from a time of stress into an opportunity for financial optimization.

Avoid the Trap: Smart Strategies to Prevent Costly Penalties from Underpaying Estimated Taxes

Article Highlights:

- Understanding Underpayment Penalties
- De Minimis Exception
- Safe Harbor Payments
- Payment Timing
- Withholding
- Annualized Payments
- Farmers and Fishermen

Underpayment penalties are a common concern for taxpayers, and many are unaware of how substantial they can be. These penalties are assessed by the Internal Revenue Service (IRS) when taxpayers fail to pay enough of their tax liability through withholding or estimated tax payments throughout the tax year. The interest rate for underpayments has been 8% per year, compounded daily, since October 1, 2023 and at least through June 30, 2024. That is

up from 3% just two or three years ago.

Understanding underpayment penalties and the strategies to avoid them can save you from unnecessary financial stress and penalties. This article will delve into the intricacies of underpayment penalties and offer guidance on how to navigate these waters effectively.

Understanding Underpayment Penalties - Underpayment penalties are essentially the IRS's way of ensuring that taxpayers are paying their taxes on a quarterly basis rather than waiting until the tax filing deadline. The IRS requires that you pay at least 90% of your current year's tax liability or 100% of the tax shown on your return for the previous year (110% if you're considered a higher-income taxpayer) throughout the year. If you fail to meet these thresholds, you may be subject to the underpayment penalty. Think of it this way: the IRS is effectively charging you interest on the tax money you kept instead of sending it to the government.

The penalty is calculated on a quarterly basis, meaning that if you underpaid in any given quarter, you might be penalized for that quarter even if you overpaid in another. The rate of the penalty is determined by the IRS and can vary from quarter to quarter. For self-employed individuals or those without sufficient withholding, estimated tax payments are a critical tool in managing tax liability and avoiding underpayment penalties. You would think that a quarter of the year would be 3 months, but for the purpose of this calculation, the "quarters" are uneven and cover January – March (3 months), April and May (2 months), June, July and August (3 months) and finally the last 4 months of the year.

De Minimis Exception - The de minimis exception is one way to avoid underpayment penalties. If your total tax liability minus your withholdings and tax credits is less than $1,000, you won't be subject to underpayment penalties. This rule is particularly beneficial for taxpayers who have a relatively small tax liability.

Safe Harbor Payments - Safe harbor payments are essentially benchmarks set by the IRS that, if met, protect taxpayers from underpayment penalties, regardless of their actual tax liability for the year. These benchmarks are designed to ensure that taxpayers pre-pay a minimum amount of their tax obligation throughout the year, either through withholding or estimated tax payments.

The general rule for safe harbor payments requires taxpayers to prepay the lesser of 90% of the current year's tax or 100% of the previous year's tax. However, for those with an adjusted gross income (AGI) over $150,000 ($75,000 if married filing separately), the rules tighten. These individuals must pay the lesser of 90% of the current year's tax or 110% of the previous year's tax to qualify for this safe harbor. Thus, the safe harbor that works for any eventuality is 110% of the previous year's tax liability. In addition, if you had no tax liability in the prior year, then you are exempt from an underpayment penalty.

Since these pre-payments consist of both withholding and estimated tax payments, the timing of these payments is also critical for payments to qualify for the safe harbor penalty exception. Estimated tax payments are due in four installments: April 15, June 15, September 15, and January 15 of the following year, approximately 2 weeks after the end of the "quarters" noted above. If any of these dates falls on a Saturday, Sunday, or legal holiday, the due date will be the next business day. Caution: Some states have different estimated payments dates and, in some cases, amounts for state estimated payments.

Withholding - Unlike estimated payments, withholding is considered paid evenly throughout the year, regardless of when it occurs. This can be particularly useful for taxpayers who realize they may fall short of their safe harbor requirements as the year progresses and boost their withholding by one means or another depending upon the increase required.

- An employee can increase their withholding for the balance of the year by providing their employer with a modified W-4 form that will cause the employer to increase withholding for the balance of the year.

- Where the increased withholding need is discovered closer to the end of the year, a cooperative employer might be willing to withhold a lump sum amount.

- 10% is the default withholding rate for nonperiodic withdrawals from traditional IRA

accounts when you fail to provide a Form W-4R to the payer that indicates your desired withholding rate (0% - 100%). Thus by submitting a Form W-4R, or a revised one, to the payer of the IRA, requesting a higher withholding rate, additional withholding can be achieved. Where you are not employed (or even if you are), you can create more tax withholding by taking a distribution and then rolling the distribution amount back into the traditional IRA or a qualified retirement plan within the statutory 60-day time frame. To achieve this strategy you will need to make up for the withholding with other funds when making the rollover and make sure you did not have another rollover in the prior 12 months since taxpayers are only allowed one IRA rollover in a 12-month period.

- Form W-4R is also used to advise payers of an eligible rollover distribution from an employer retirement plan of the desired withholding rate if it is other than the default rate of 20%.

- Form W-4P should be completed to have payers withhold the correct amount of federal income tax from the taxable portion of a periodic pension, annuity (including commercial annuities), profit-sharing and stock bonus plan, or IRA payments. Periodic payments are made in installments at regular intervals (for example, annually, quarterly, or monthly) over a period of more than 1 year.

Calculating the Penalty – If you file your return, owe more than $1,000 and don't meet an exception, the IRS will compute the underpayment penalty and bill you for it. However, IRS Form 2210 (2210-F for farmers and fishers) can be used to calculate the required annual payment and determine if you have underpaid in any quarter of the tax year. The form considers the amount of tax owed, estimated tax payments made, and any withholding. It then calculates the penalty based on the underpayment for each quarter until the due date of the tax return or until the underpayment is paid, whichever comes first.

If your income varies significantly throughout the year, the annualized income installment method can help reduce or eliminate underpayment penalties. This method allows you to calculate your tax liability and corresponding estimated payments based on your actual income for each quarter, rather than assuming an even income distribution throughout the year.

Farmers and Fishermen - There are special estimated tax requirements for farmers and fishermen. Farmers and fishermen, with at least two-thirds of their gross income for the prior year or the current year from farming or fishing, have two options:

- They may pay all their estimated tax by January 15th (which is the 4th quarter due date for estimated taxes), or
- They can file their tax return on or before March 1st and pay the total tax due at that time.

The required estimated tax payment for farmers and fishermen is the lesser of:

- 66 2/3% of the current year's tax, or
- 100% of the prior year's tax.

These provisions are designed to accommodate the unique income patterns of farmers and fishermen, who may not have steady income throughout the year and often realize the bulk of their income at specific times of the year.

Navigating the complexities of underpayment penalties requires a proactive approach to tax planning and payment. By understanding the rules and utilizing strategies such as adjusting withholdings, making estimated tax payments, and taking advantage of the safe harbor rule and the de minimis exception, taxpayers can avoid the financial sting of underpayment penalties. Remember, the goal is to manage your tax liability throughout the year effectively, so you're not caught off guard come tax season.

If you're unsure about your tax situation, please contact this office for personalized advice and peace of mind.

Think Twice Before Tossing: The Critical Timing for Disposing of Your Tax Records Safely

Article Highlights:

- **Why We Keep Records**
  - Audit Defense
  - Amending Returns
  - Claiming Refunds
  - Tax Basis
- **Duration for Keeping Tax Records**
  - Federal Statute of Limitations on Tax Refunds
  - Tax Return Omissions
  - Indefinite Retention
  - Financially Disabled
- **The Big Problem!**
  - Stock Acquisition Data
  - Stock and Mutual Fund Statements
  - Tangible Property Purchase and Improvement Records
- **The 10-Year Statute of Limitations on Collections**

Now that your taxes are complete and filed for last year, you are probably wondering what old tax records can be discarded. If you are like most taxpayers, you have records from years ago that you are afraid to throw away. To determine how to proceed, it is helpful to understand why the records needed to be kept in the first place. Generally, we keep "tax" records for several reasons:

- *Audit Defense*: In the event of an IRS audit, taxpayers are required to present documentation supporting the claims made on their tax returns. Without proper records, defending against audit adjustments becomes significantly challenging.

- *Amending Returns*: If taxpayers need to amend a return due to discovered errors or overlooked deductions, having detailed records makes the process smoother and ensures that all adjustments are accurate.

- *Claiming Refunds*: For claiming refunds, especially those related to overpaid taxes, detailed records are necessary to substantiate the claim.

- *Tax Basis*: When capital assets, such as stock, business assets, rentals and other investments are disposed of it is necessary to determine for tax purposes if there was a gain or loss from the transaction. The tax basis is what the asset cost plus or minus adjustments such as the cost of improvements which increase the tax basis, depreciation (reduces basis), casualty losses, or tax credits which decrease the tax basis.

Duration for Keeping Tax Records - The general rule of thumb is to keep tax records until the statute of limitations for the tax return in question expires. The statute of limitations is the period during which the taxpayer can amend their tax return to claim a credit or refund, or the IRS can assess additional tax.

- *Federal Statute of Limitations* on Tax Refunds: The statute of limitations on tax refunds is a set of rules defined by the Internal Revenue Code that determines the time frame within which a taxpayer can claim a credit or refund for overpaid taxes. This statute serves two main purposes:

  - It specifies how long an individual has to file a claim for a refund or an amended return after the original return was filed or the tax was paid.

  - It sets limits on the amount of refund or credit that can be claimed, based on certain conditions.

- Some states have longer statutes, typically 4 years, so they have more time to piggyback on any federal audits and adjustments.

- *Example: Sue filed her 2023 tax return before the due date of April 15, 2024. She will be able to safely dispose of most of her records after April 15, 2027. On the other hand, Don files his 2023 return on June 2, 2024. He needs to keep his records at least until June 2, 2027. In both cases, the taxpayers should keep their records a year or two longer if their states have a statute of limitations longer than three years. Note: If a due date falls on a Saturday, Sunday or holiday, the due date becomes the next business day.*

Tax Return Omissions: In certain situations, such as when a taxpayer does not report income that they should report, and it is more than 25% of the gross income shown on the return, the IRS suggests keeping records for six years.
Of course, the statute doesn't begin running until a return has been filed. There is no limit on the assessment period where a taxpayer files a false or fraudulent return to evade tax.
Indefinite Retention: For records related to property, the IRS recommends keeping them for as long as the property is owned and for at least three years after filing the return reporting the sale or other disposition of the property. This is crucial for calculating depreciation, amortization, or gains or losses on the property.

Financially Disabled - Additionally, the time periods for claiming a refund are suspended for taxpayers who are "financially disabled". A taxpayer is financially disabled if they are unable to manage their financial affairs because of a medically determinable physical or mental impairment that can be expected to result in death or that has lasted or can be expected to last for a continuous period of not less than 12 months. For a joint income tax return, only one spouse need be financially disabled for the time to be suspended. However, a taxpayer is not treated as financially disabled during any period their spouse, or any other person, is authorized to act on their behalf in financial matters.

The Big Problem! The problem with discarding records indiscriminately for a particular year once the statute of limitations has expired is that many taxpayers combine their normal tax records and the records needed to substantiate the basis of capital assets such as stocks, bonds, and real estate. These documents need to be separated, and the basis records should not be discarded before the statute expires for the year in which the asset is disposed. Thus, it makes more sense to keep those records separated by asset. The following are examples of records that fall into this category:

- *Stock Acquisition Data* — If you own stock in a corporation, keep the purchase records for at least four years after the year the stock is sold. This data will be needed to prove the amount of profit (or loss) you had on the sale. And if the result of those sales, and sales of other capital assets, is a loss that you'll be carrying forward to future tax returns – loss exceeds $3,000 ($1,500 if filing as married separate) – keep the purchase and sale records for four years after filing the return on which the last of the loss is used up.

- *Stock and Mutual Fund Statements* — Many taxpayers use the dividends that they receive from a stock or mutual fund to buy more shares of the same stock or fund. The reinvested amounts add to the basis in the property and reduce gains when the stock is finally sold. Keep statements for at least four years after the final sale.

- *Tangible Property Purchase and Improvement Records* — Keep records of home, investment, rental property or business property acquisitions, AND related capital improvements for at least four years after the underlying property is sold.

In addition, if you own a business that has a loss that creates a net operating loss (NOL) that you'll be carrying forward to deduct in future years, you should keep all the business's records that substantiate income and expenses from the loss year for at least four years after filing the return on which the NOL deduction is used up.

The 10-Year Statute of Limitations on Collections – Although this has nothing to do with the theme of his article, "how long does the IRS have to collect unpaid tax?" is an often-asked question. The tax code puts a 10-year limit on the time period the IRS can pursue the collection of a tax debt. This statute of limitations begins from the date the tax was assessed and not from the tax year for which the debt was incurred. Understanding this limitation is crucial for taxpayers for several reasons:

- *Collection Activities*: The IRS has various collection activities at its disposal, including tax liens, levies, and wage garnishments. However, these activities are bound by the 10-year statute of limitations.

- *Installment Agreements*: When a taxpayer owes federal tax and can't immediately pay it, they may enter into an installment payment agreement with the IRS. In this case the clock on the 10-year statute does not stop. This means the IRS must collect the full amount owed within the original 10-year period unless specific conditions extend this period.

Have questions about whether to retain certain records? Give this office a call before tossing out those documents. It is better to be sure before discarding something that might be needed down the road.

Thank you for selecting our firm for your tax and accounting needs. We appreciate the confidence you have shown in us, and we remain ready to assist you at any time.

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