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# Leslie A. Cesario, Ltd.
# Monthly Newsletter

## Dodging Tax Penalties

**Article Highlights:**

- Unintentional Penalties
- Underpayment of Estimated Tax and Withholding
- Late Payment Penalty
- Late Filing Penalty
- Negligence Penalty
- Dishonored Check Penalty
- Missing ID Number Penalty

Most taxpayers don't intentionally incur tax penalties, but many who are penalized are simply not aware of the penalties or the impact they can have on their wallet. As tax season approaches, let's look at some of the more commonly encountered penalties and how they may be avoided.

**Underpayment of Estimated Taxes and Withholding** – Taxpayers are required to pay their tax liability as they go during the year, either through withholding or by making estimated tax payments. If the taxpayer owes more than $1,000 when filing his or her return for the year, the IRS will assess the underpayment of estimated tax penalty, which is currently 4% of the underpayment computed quarterly. There are "safe harbor" payments that can protect you from this penalty, which include payments in the following amounts: 90% of the current year's tax liability or 100% (110% for high-income taxpayers) of the prior year's tax liability. Farmers and fishermen need only prepay 66-2/3% of the current liability or 100% of the prior year's liability.

**Late Paying Penalty** – When the tax owed on a return is paid after the unextended due date of the tax return (usually April 15), the taxpayer is subject to a penalty of 1/2% per month (maximum 25%) on the unpaid balance. Taxpayers are frequently caught by this penalty when they need an extension to file their tax return. Many fail to realize that the extension does not include an extension to pay. The only way to avoid or minimize this penalty is to have no or little balance due on the return when it is finally filed. The extension form includes a provision to pay the projected balance owed when filing the extension.

**Late Filing Penalty** – If the return is filed after the due date, including extensions, a late filing penalty of 4.5% per month (maximum 22.5%) applies. The <u>automatic</u> extended due date for 2016 returns is October 18, 2017, but an extension request form must be filed by the April 2017 due date to qualify. Thus, the penalty would generally apply to 2016 returns filed after October 18, 2017. If the return is over 60 days late, the minimum penalty for failure to file is the lesser of $205 or 100% of the tax shown on the return. While the obvious way to avoid a late filing penalty is to file in a timely fashion, the IRS will consider abating the penalty if it can be proven that there was reasonable cause and no willful neglect for filing late.

**Negligence** – When underpayment is due to negligence on the part of the taxpayer or when there are errors in tax valuations, 20% of the tax underpayment is charged. This penalty is frequently encountered when the IRS adjusts a filed return due to unreported income or overstated deductions. To reduce the chance that you may be subject to this penalty, be sure you provide all of your W-2s, 1099s, K-1s, etc. for the preparation of your return, complete any organizer that have been requested and ensure that you can substantiate all of the deductions you claim.

**Dishonored Check** – The penalty for dishonored checks is 2% of the check amount, but if the amount is $1,250 or less, the penalty is the amount of the check or $25, whichever is less. If you don't have sufficient funds to pay your tax when you file your return, rather than writing a check that you know will bounce, you may be able to arrange an installment payment plan with the IRS. You may still incur late payment charges, but the penalty rate is lower if you are on a payment plan.

**Missing ID Number** – This penalty of $50 for each missing number is charged when a taxpayer doesn't provide a required Social Security number (SSN) for him or herself, a dependent or another person on his or her tax return or doesn't. It is also charged when the taxpayer doesn't provide his or her SSN to another person or entity when required.

There are more severe penalties not mentioned here that apply to fraudulent actions or claims. In addition to the late filing penalty, it is possible to have some of the other penalties abated for reasonable causes. If you have questions related to the application of any of these penalties, please give this office a call.

## Not Business as Usual for Employers: W-2 and 1099-MISC Filing Dates Moved Up

**Article Highlights:**

- Fraudulently Filed Tax Returns
- Delayed Refunds
- New W-2 and 1099-MISC Filing Due Dates
- W-2 Extensions No Longer Automatic

The IRS, in an effort to combat rampant tax filing fraud, has introduced what they hope will be two new fraud-prevention measures for the upcoming filing season. The first will purposely delay until February 15 the issuance of refunds for tax returns where there is an earned income tax credit (EITC) and/or a refundable child tax credit (CTC), giving the IRS more time to match the income reported on these returns to the income reported by employers. These two tax credits have been the favorite target of scammers who have been filing fraudulent returns with stolen IDs and fabricated income before the IRS is able to verify the income and withholding claimed on the returns.

The second preventive measure is to require earlier filing of W-2 and 1099-MISC forms, which will enable the IRS to ferret out returns that report phony income and withholding. This measure will have a significant impact on employers by moving up the filing due date of the government's copy of 2016 W-2s and 1099-MISCs to January 31, 2017 (the previous due date was February 28, or March 31 if filed electronically). January 31 has been and continues to be the date the forms are required to be provided to the employees (W-2s) or independent contractors (1099-MISCs).

The 30-day automatic extension to file W-2s is no longer automatic. The IRS anticipates that it will grant the non-automatic extension of time to file only in limited cases where the filer or transmitter's explanation demonstrates that an extension of time to file is needed as a result of extraordinary circumstances.

With regard to the government's copy of 1099-MISC forms, the earlier filing due date only applies to those 1099-MISC forms reporting non-employee compensation.

If you have questions related to earlier W-2 or 1099-MISC filing requirements, please give this office a call.

## Tax Benefits for Single Parents

**Article Highlights**:

- Filing Status
- Child Support
- Alimony
- Exemptions
- Child Care Credit
- Child Tax Credit
- Earned Income Tax Credit

If you are a single parent dealing with the complicated tasks of working and raising a family, there are some tax benefits and issues you should be aware of.

*Filing Status* – Just because you are single or widowed does not mean you have to file your tax returns using the single filing status. Tax law provides two far more beneficial filing statuses that you might qualify for. These statuses provide higher standard deductions and more beneficial tax rates:

> **Head of Household** – If you are unmarried and pay more than half the cost of maintaining a household that is the principal place of abode for your qualified child or children for more than one-half of the year, then you qualify for the head of household status. Qualified children generally include your children, grandchildren, foster children or stepchildren under the age of 19 or a full-time student under the age of 24 who is not self-supporting. This is true even if you allow the other parent to deduct the dependency exemption for the child.
>
> **Qualified Widow** – If you are widowed, you may qualify for the head of household status discussed just above. However, if your spouse passed away in one of the two prior years, you have a child or stepchild (not including a foster child or grandchild) whom you can claim as a dependent and who lived with you the whole year, and you paid more than half the cost of keeping up the home, you can use the higher standard deduction for married individuals filing jointly. In comparison, in 2016, the standard deduction for marrieds filing jointly is $12,600, which is twice the amount for a single individual.

*Child Support* – Any child support you receive from the non-custodial parent is tax-free to you. Child support is also not included in household income for the purposes of determining the premium tax credit if you are otherwise qualified and obtain your health insurance through a government marketplace.

*Alimony* – In most cases alimony payments received from your former spouse must be included in your income and are subject to tax. However, you can treat the alimony as earned income for purposes of making an IRA contribution of as much as $5,500 ($6,500 for those age 50 and over).

*Exemptions* – You are entitled to an exemption allowance of $4,050 for yourself and each of your children and others whom you claim as dependents on your tax return. Generally, the custodial parent will be the one eligible to claim a child’s exemption allowance. The value of the exemptions you claim is subtracted from your gross income when you are figuring out the amount of your taxable income. For example, if you are in the 25% tax bracket, each exemption allowance you deduct saves you $1,013 of tax. However, if you allow the non-custodial parent to claim the exemption of a qualified child, then you forego the $4,050 exemption allowance for that child.

Releasing the exemption of a child to the noncustodial parent must be done in writing and to IRS's specifications as to required information. The noncustodial parent must then attach the written form to his or her return. The release can be for one year, for specified years or for all future years. If the exemption for the child is released, then the noncustodial parent will be able to claim the child tax credit (discussed below). Note: If a child is older and attending college, keep in mind when relinquishing the child's exemption that the partially refundable tuition credit goes to the one who claims the child.

*Child Care Credit* – If your child or children are under age 13, and you are working or attending school, you may qualify for the non-refundable child and dependent care credit, which is based upon the amount of your earnings from working (or imputed income if attending school) and the amount of child care expenses, up to $3,000 for one child and $6,000 for two or more children. The credit can be as much as $1,050 for one child and $2,100 for two.

*Child Tax Credit* – You are also entitled to a non-refundable tax credit of $1,000 for each child under the age of 17 that you claim as a dependent. However, this credit begins to phase out for those filing as head of household with incomes in excess of $75,000. Some taxpayers with lower income may qualify for some portion of this credit to be refundable.

*Earned Income Tax Credit (EITC)* – If you are working, you may also qualify for the EITC. This refundable credit is available to lower-income taxpayers and is based on your income and the number of children you have, up to three. The maximum credits for 2016 are $506 with no children, $3,373 with one, $5,572 with two, and $6,269 with three or more. The credit is totally phased out at incomes of $14,880 with no children, $39,296 with one, $44,648 with two, and $47,955 with three or more.

As you can see, there are a number of tax benefits that apply to single parents. Please consult with this office to be sure you are not missing out on one or more of the benefits available to you. If you are a custodial parent, before releasing your child's exemption to the noncustodial parent, you may wish to contact this office so the tax impact on your return(s) can be determined.

## Congress Gives Small Employer HRAs the Green Light

**Article Highlights:**

- 21st Century Cures Act
- Background
- Qualified Small Employer
- Eligible Employees
- Reimbursement Limits
- Transitional Relief

Congress has approved the 21st Century Cures Act, which includes a provision allowing small employers to reimburse their employees for medical expenses under a health reimbursement arrangement without being liable for the draconian, $100 per day penalty for violating the Affordable Care Act's rules. President Obama has indicated his approval of the bill.

**Background:** Stand-alone HRAs do not meet two key requirements of the ACA, as they:

- Limit the dollar amount of the insured person's annual benefits and
- Fail to provide certain preventive-care services without requiring cost-sharing.

As a result, under the IRS' interpretation of the ACA, employers are subject to a $100 per day (maximum $36,500 per year) excise tax penalty per employee.

**New Law:** Effective January 1, 2017, under the 21st Century Cures Act, qualified small employers that have an average of fewer than 50 full-time employees (including full-time-equivalent employees) and that maintain a qualified small-employer HRA will be exempt from the penalty. Under this act, a qualified small employer is one that:

(1) Employs an average of fewer than 50 full-time employees (including full-time-equivalent employees) and does not offer a group health plan to its employees. The number of full-time-equivalent employees is determined by adding up all the hours that part-time employees worked in a given month and dividing by 120.

(2) Provides the HRA on the same terms to all eligible employees. Eligible employees all those except:
   a. Those who have not completed 90 days of service,
   b. Those who have not attained the age of 25,
   c. Part-time workers (generally those working an average of less than 30 hours per week),
   d. Seasonal workers (generally those employed for 6 months or fewer during the year),
   e. Those covered by a collective bargaining unit, and
   f. Certain nonresident aliens.

(3) Entirely funds the HRA (i.e., no salary-reduction contribution is made to the HRA).

(4) Only reimburses the employees after being provided with proof of their medical expenses.

(5) Limits reimbursements to $4,950 ($10,000 where the plan includes family members) per year. Amounts are subject to inflation adjustments for years after 2016.

Although this law is effective January 1, 2017, transitional relief is generally provided for any HRA plan beginning on or before December 31, 2016.

Any medical-expense reimbursements that an employee receives from a qualifying HRA are excluded from that employee's income.

If you have questions, please give the office a call.

## Thinking of Becoming a Real Estate Flipper? Here's a Primer on the Tax Rules Article Highlights:

- Definition of Flipping
- Government Will Share in the Profits
- Tax Treatment Depends on Being a Dealer, Investor or Homeowner
- Distinguishing a Dealer from an Investor

With mortgage interest rates low and home prices finally making a comeback, flipping real estate appears to be on the rise. This activity is even the theme of several popular reality TV shows. House flipping is, essentially, purchasing a house or property, improving it and then selling it (presumably for a profit) in a short period of time. The key is to find a suitable fixer-upper that is priced under market for its location, fix it up and resell it for more than it cost to buy, hold, fix up and resell.

Are you contemplating trying your hand at flipping? If so, keep in mind that you will have a silent partner, Uncle Sam, who will be waiting to take his share of any profits in taxes. (And most likely, Sam's cousin in your state capitol will expect a share, too.) Taxes play a significant role in the overall transaction, and tax treatment can be quite different depending upon whether you are a dealer, an investor or a homeowner. The following is the current tax treatment for each.

- _Dealer in Real Estate_ – Gains received by a non-corporate taxpayer from business operations as a real estate dealer are taxed as ordinary income (10% to 39.6%), and in addition, individual sole proprietors are subject to the self-employment tax of 15.3% of their net profit (the equivalent of the FICA taxes for a self-employed person). Higher-income sole proprietors are also subject to an additional 0.9% Medicare surtax on their earnings. Thus, a dealer will generally pay significantly more tax on the profit than an investor. On the other hand, if the flip results in a loss, the dealer would be able to deduct the entire loss in the year of sale, which would generally reduce his or her tax at the same rates.
- _Investor_ – Gains as an investor are subject to capital gains rates (maximum of 20%) if the property is held for more than a year (long term). If held short term (less than a year, as will likely be the case for most flippers), ordinary income rates (10% to 39.6%) will apply. An investor is not subject to the self-employment tax, but could be subject to the 3.8% surtax on net investment income for higher-income taxpayers. A downside for the investor who has a loss from the transaction is that, after combining all long- and short-term capital gains and losses for the year, his or her deductible loss is limited to $3,000, with any excess capital loss being carried over to the next year. The rules get a bit more complicated if the investor rents out the property while trying to sell it, but such rules are beyond the scope of this article.
- _Homeowner_ – If the individual occupies the property as the primary residence while it is being fixed up, he or she would be treated as an investor, with three major differences: (1) if the individual has owned and occupied the property for two years and has not used a homeowner gain exclusion in the two years prior to closing the sale, he or she can exclude gain of up to $250,000 ($500,000 for a married couple); (2) if the transaction results in a loss, the homeowner will not be able to deduct the loss or even use it to offset gains from other sales; and (3) some fix-up costs may be deemed to be repairs rather than improvements, and repairs on one's primary residence are neither deductible nor includible as part of the cost basis of the home.

Being a homeowner is easily identifiable, but the distinction between a dealer and an investor is not clearly defined in the tax code. A real estate dealer is a person who buys and sells real estate property with a view to the trading profits to be derived and whose operations are so extensive as to constitute a separate business. A person acquiring property strictly for investment, though disposing of investment assets at intermittent intervals, generally does not deal in real estate on a regular basis.

This issue has been debated in the tax courts frequently, and both the IRS and the courts have taken the following into consideration:

- whether the individual is already a dealer in real estate, such as a real estate sales person or broker;
- the number and frequency of sales (flips);
- whether the individual is more committed to another profession as opposed to fixing up and selling real estate; and
- how much personal time is spent making improvements to the "flips" as opposed to another profession or employment.

The distinction between a dealer and an investor is truly based on the facts and circumstances of each case. Clearly, an individual who is not already in the real estate profession and flips one house is not a dealer. But one who flips five or more houses and/or properties and has substantial profits would probably be considered a dealer. Everything in between becomes various shades of grey, and the facts and circumstances of each case must be considered.

If you have additional questions about flipping real estate or need assistance with your specific situation, please give this office a call.

## Better to Sell or Trade a Business Vehicle?

**Article Highlights:**

- Replacing a Business Vehicle
- Selling the Old Vehicle at a Loss
- Trade-in is Treated as an Exchange
- Prorate if Used for Business and Personal

As the end of the year approaches, business owners may be thinking about replacing a business vehicle – profits from the business may be up, so the timing may be right to acquire a new vehicle, or the current vehicle may finally be on its last legs. A question then comes up: Is it better to sell the current vehicle outright or trade it in for a new vehicle?

When replacing a business vehicle, it does make a difference for tax purposes if you decide to sell or trade it in for the replacement vehicle. If you sell a vehicle, the resulting gain or loss is reported on your tax return. As a result, it is generally better to sell a vehicle if the disposition of the vehicle will result in a loss. Since trade-ins are treated as an exchange and any gain or loss is absorbed into the replacement vehicle's depreciable basis, it is generally better to trade in a vehicle that would result in a gain.

*As an example, suppose you sell your business vehicle for \$12,000. Your original purchase price was \$32,000, and \$17,000 has been taken in depreciation. As illustrated below, the sale results in a loss, so it generally would be better for you to sell the vehicle and deduct the loss rather than trading in the vehicle.*

| | | |
|---|---|---|
| *Sales price* | | *\$12,000* |
| *Cost* | *\$32,000* | |
| *Depreciation Taken* | *<\$17,000>* | |
| *Depreciated Basis* | | *<\$15,000>* |
| *Loss* | | *<\$ 3,000>* |

*On the other hand, had you sold the business vehicle for \$16,000, the sale would result in a \$1,000 taxable gain and trading it in would be a better option.*

If the vehicle is used for both business and personal purposes, the loss or gain must be prorated for the business use. No loss would be deductible on the personal portion.

Since trade-in values are generally lower than the actual sales value of the vehicle, the trade-in decision must also consider whether the tax benefits exceed the additional money that might be received from selling the old business vehicle.

This concept can also be used when selling or disposing of other business assets.

If you are planning to replace a business vehicle and would like to discuss how its disposition and the purchase of a new vehicle will affect your tax situation, please give this office a call.

## 10 Questions to Ask Your Financial Team When Starting Up

Starting up your business is an exciting time, but it is also a time with many questions. While it may seem initially very easy to create a product, open a store, and start selling, the financial aspects of being successful are a bit more challenging. As you consider the process of starting up, work with a local financial planning team and tax professional to ensure you get your financial footing in place now. Ask these questions.

### #1: What should be in a basic business plan?

A business plan should outline each detail of your company including who will run it, how much you'll charge, and what you expect to earn. Putting time into creating a thorough business plan is important. Work with your team to ensure your plan is accurate and represents your business well.

### #2: Who will you need to pay taxes to?

Your local jurisdiction and state have specific taxation requirements. You'll likely have to pay taxes on sales, but also costs associated with payroll. Ensure your accountant not only talks to you about who you need to pay, but payment deadlines as well.

### #3: What is a projected cash flow for the business?

How much cash does your company need to keep on hand? The key here is to be able to anticipate how much it will cost you to operate your business. Most companies should not expect to have positive cash flow for at least a year, often longer. Your professionals can help you decide what your cash flow projections are.

### #4: How much of an investment do you need to put into your company right now?

Your financial team can help you project the cost of setting up your new business. This will include costs related to establishing the physical business and paying for supplies. Your initial investment generally will be the highest amount put into the company by the founder, but it changes significantly from one company to the next.

### #5: What is your break-even analysis?

This may be an important question to ask early on. How much do you need to make to break even? You'll want to talk to your financial team about the timeline for this and what can be done to help ensure you break even as soon as possible.

### #6: What liability insurance do you need?

While most tax professionals don't offer recommendations here, having adequate policies to cover potential loss is important. Work with your team to ensure you have comprehensive protection to minimize risks against your company's financial health.

**#7: What will interest cost you?**

Interest on loans is not something to overlook. You'll want to ensure you have an accurate representation of how much you are paying in interest so you can make adjustments to pay off any borrowed debt sooner, make better decisions about borrowing, or factor in the cost.

**#8: How will you manage payroll?**

This is a very big component of starting up since it can be troublesome for most startups to actually know how to pay employees and meet all federal and state requirements. Working with a payroll provider is often the easiest option (and most financially secure since paying an employee to do this work tends to be more expensive).

**#9: How can you reduce your taxes?**

Tax professionals will work with you to determine if there are any routes to reducing taxation on your business including local incentives that may be available. You'll also want to talk about projects taxes, investments that could reduce taxes, and having all possible deductions in place.

**#10: What's the right profit margin?**

Working with a financial team often comes down to this question. How much should you charge to make the best profit possible while still ensuring your company can grow? It's not a simple question, but having the right team by your side ensures it will be clarified as much as possible.

Working with tax and accounting professionals is the most important decision any startup founder needs to take long before any commitments are made. It is here that you will formulate the success for your company.