PEDELAHORE & CO
CERTIFIED PUBLIC ACCOUNTANTS
Tax-Saving Tips

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Estimated Tax Penalties

The United States has a "pay as you go" tax system in which payments for income tax (and, where applicable, Social Security and Medicare taxes) must be made to the IRS throughout the year as income is earned, whether through withholding, by making estimated tax payments, or both.

You suffer an estimated tax penalty if you don't pay enough to the IRS during the year.

The IRS levies this non-deductible interest penalty on the amount you underpaid each quarter. The penalty rate equals the short-term interest rate plus three percentage points.

Due to the rise in interest rates, the current penalty rate is 8 percent—the highest in 17 years. And since it's not deductible, the net cost likely far exceeds 8 percent.

If you are an employee and have all the tax you owe withheld by your employer, you don't have to worry about this penalty.

But you must worry about it if you're self-employed, because no one withholds taxes from your business income. Likewise, you must worry if you receive income from which no, or not enough, tax is withheld—for example, retirement distributions, dividends, interest, capital gains, rents, and royalties.

C corporations are also subject to the underpayment of estimated tax penalty. Fortunately, it's easy to avoid this penalty!

- All individual taxpayers have to do is pay (1) 90 percent of the total tax due for the current year or (2) 100 percent of the total tax paid the previous year (110 percent for higher-income taxpayers with adjusted gross income of more than $150,000 ($75,000 for married couples filing separately).

- Corporations must pay 100 percent of the tax shown on their return for the current or preceding year (but large corporations can't use the prior year).

Most individuals and corporations make *equal* quarterly estimated tax payments to the IRS. The IRS applies the penalty separately for each payment period. Thus, you can't reduce the penalty for one period by increasing your estimated tax payments for a later period. This is true even if you're due a refund when you file your tax return.

Some individuals and corporations can use alternate methods for computing estimated taxes, such as the annualized income method. But the alternate methods can be complicated.

The IRS Annual Dirty Dozen List

Have you heard about the enormous tax savings you can reap by investing in a Maltese individual retirement arrangement or utilizing Puerto Rican captive insurance for your business? Before you invest your hard-earned

money in these or other highly promoted tax schemes, you should check the IRS Dirty Dozen list.

For over 20 years, the IRS has issued an annual Dirty Dozen list identifying tax scams and avoidance schemes. This year's list includes everything from employee retention credit claims to the use of fake charities.

Some items on the Dirty Dozen list involve fraud, such as identity theft through "spearphishing." Other items involve tax credits or deductions, such as conservation easements, that can be legitimate but have been prone to abuse by taxpayers in the IRS's view.

The Dirty Dozen gives you red flags that trigger IRS scrutiny and can result in aggressive enforcement action against taxpayers who claim such deductions or credits and those who promote them.

When you see a new item on the Dirty Dozen list, especially if it's at the top, you know it's something the IRS is particularly interested in. A case in point is the employee retention credit (ERC). It didn't make it to the list until 2023, and then the IRS placed it on the top.

The top position tells you that combating fraudulent ERC claims is a high priority for the IRS. This doesn't mean you should avoid claiming the ERC if you're entitled to it. Just make sure you have all the necessary records in case of an audit.

As part of its Dirty Dozen awareness effort, the IRS encourages members of the public to report individuals who promote improper and abusive tax schemes as well as tax return preparers who deliberately prepare improper returns. The IRS also created an Office of Promoter Investigations in 2021 to identify and stop promoters and enablers of abusive tax avoidance transactions.

Employing a strategy or scheme on the Dirty Dozen list makes an audit more likely. It can also result in substantial tax penalties if an audit occurs and the IRS concludes that taxes were underpaid due to the use of the strategy. The fact that the strategy was on the Dirty Dozen list can make it difficult to avoid such penalties, which the IRS can impose on

- taxpayers
- tax preparers, and
- promoters.

Taxpayers can avoid the accuracy-related penalty if they establish that they had reasonable cause for the underpayment and acted in good faith. But it is challenging, if not impossible, for taxpayers to demonstrate that they acted in good faith when they adopt a strategy or scheme listed in the IRS's Dirty Dozen list.

Tax Implications of Selling Qualified Improvement Property (QIP)

You need to think about the sale of your rental property when you claim depreciation on your qualified improvement property (QIP).

Gains may be subject to higher-than-expected tax rates due to Section 1245 and Section 1250 ordinary income recapture and other factors. Planning your depreciation methods can significantly impact your current tax liabilities and long-term taxable gains when you sell.

Do you own or are you thinking of owning an office building, a store, a warehouse, or a factory building?

Are you thinking of making improvements to the interior of this building?

If you make improvements to the interior that the tax law classifies as QIP, your commercial property now has three property components:

1. Land (non-depreciable)
2. Building (depreciated over 39 years using the straight-line method)
3. QIP (depreciated over 15 years using the straight-line method, but alternatively eligible for Section 179 expensing and bonus depreciation)

Technically, QIP means any improvement to an interior portion of a *non-residential building* (think offices,

stores, factories, etc.) that is placed in service after the date the building is placed in service.

The exceptions are costs attributable to the enlargement of the building, any elevator or escalator, or the building's internal structural framework.

QIP Deduction Choices

QIP is 15-year property eligible for deduction in three ways:

1. Straight-line depreciation using the IRS 15-year depreciation table
2. Section 179 expensing
3. Bonus depreciation (technically called "additional first-year depreciation" in the tax code)

You can use a combination of the above to deduct your QIP—except when bonus depreciation is 100 percent, because that uses 100 percent of your basis in the QIP.

Bonus Depreciation

Lawmakers are in the process of reinstating 100 percent bonus depreciation for 2022 and 2023.

Regardless of the bonus deduction percentage—60 percent, 80 percent, or 100 percent—the rules for taxing that deduction when you sell are the same.

The reason to claim the deduction is that it's immediate. For example, let's say you spend $120,000 on QIP. With 100 percent bonus depreciation, you deduct $120,000 the year you place the QIP in service.

Caution. Make sure the passive loss rules don't limit the QIP bonus depreciation deduction.

When you sell the building that contained the QIP for which first-year bonus depreciation was claimed, gain—up to the excess of the bonus depreciation deduction over the depreciation calculated using the straight-line method—is considered additional depreciation for purposes of Section 1250 and is high-taxed ordinary income recapture.

Section 179 Expensing

When you sell QIP for which first-year Section 179 deductions were claimed, gain up to the amount of the Section 179 deductions is high-taxed Section 1245 ordinary income recapture.

Straight-Line Depreciation

If you opt for straight-line depreciation for real property, including QIP (that is, no first-year Section 179 deductions and no bonus depreciation), there won't be any Section 1245 or Section 1250 ordinary income recapture.

Instead, you will have only *unrecaptured Section 1250 gain* from the depreciation, and that gain will be taxed at a federal rate of no more than 25 percent.

Planning for the QIP Deductions

As you see above, your QIP deduction is not what it appears on the surface. Regardless of how you deduct your QIP, immediately or over time, you have a deduction that turns into taxable income at the time of sale.

So, what to do? If you want the big deduction in the first year, go for it, but

- make sure you will realize that deduction—in other words, make sure the passive-loss rules don't deny or defer that deduction; and
- make sure you consider what is going to happen in the year you plan to sell the property.