HARPER | PEARSON

Tax Newsletter

**Meet Your Estimated Tax Obligations**
**How to avoid underpayment penalties**

Do you receive income other than regular wages during the year? Notably, you may be required to pay quarterly installments of “estimated tax” for this year, especially if you are self-employed or retired and living mainly on investment income.

The due date for the next installment—the third one for the 2023 tax year—is September 15, 2023. The last one for the 2023 tax year is January 16, 2024. **Note:** New legislation proposed in Congress would change the quarterly due dates to line up more evenly during the year.

**Basic rules**: Generally, you are required to pay annual income tax in quarterly installments or through payroll tax withholding or a combination of the two. The quarterly due dates for estimated tax payments under current law are as follows: April 15, June 15, September 15 and January 15 of the following year (or the following business day if the regular due date falls on a weekend or holiday). Thus, the due date for the fourth quarter of 2023 is moved to Tuesday, January 16, 2024 because Martin Luther King Jr. Day is on Monday, January 15.

If you do not pay the requisite amount of estimated tax during the year, you may be assessed an underpayment penalty, plus interest. However, you can avoid any tax problems for the year through any one of the following safe-harbor methods.

- Pay at least 90% of the current year’s tax liability. Thus, you will have to make a reasonable estimate of the tax you will owe this year.

- Pay at least 100% of the prior year’s tax liability or 110% if your adjusted gross income (AGI) for the prior year exceeded $150,000. This takes the guesswork out of the payment because you know the exact amount of your 2022 tax liability.

- Pay at least 90% of the current year’s "annualized income." This method works well for certain individuals, such as independent contractors, who receive most or all of their income on a seasonal basis.

How much is the underpayment penalty? The IRS applies a specified percentage to compute the penalty amount for each quarter. For instance, the rate for underpayments in the third quarter of 2023 is 7%.

The IRS also provides taxpayers with some help in figuring out estimated tax liability by including a worksheet in the tax form instructions. But this can get somewhat complicated, so do not hesitate to ask for assistance from your professional tax advisors.

Under the new proposed legislation, the due date for each quarterly installment would be 15 days after the close of the quarter. Thus, each installment would be three months apart. In comparison, the current June 15 due date is only two months apart from the April 15 due date. We will watch out for new developments. In the meantime, here is some—

**Practical advice:** Sit down with an advisor to determine the best course of action for the rest of the year. This should take into account all the relevant factors for your situation.

**Serving Up a Cafeteria Plan**
**Offer menu of fringe benefits**

Fringe benefits are valued by employees, but are often expensive for employers. Your small company may not be able to provide all the benefits you know that your employees want.

One potential solution is to use a "cafeteria plan." As the name implies, it offers a menu of benefits for employees to choose from, thereby reducing the overall cost. If certain requirements are met, the benefits are tax-free to employees and tax-deductible by the company. It is a win-win.

**Basic overview:** Cafeteria plans are governed by Section 125 of the tax code. To qualify for favorable tax treatment, the plan must be in writing and maintained by an employer in accordance with the law and the applicable regulations. Assuming these requirements are met, participants receive the selected benefits on a pre-tax basis. Each participant can choose between a taxable benefit, like cash, and various tax-exempt benefits.

The tax-exempt benefits that are offered may include the following goodies.

- Accident and health benefits;
- Adoption assistance;
- Dependent care assistance;
- Flexible spending accounts (FSAs);
- Group-term life insurance coverage above $50,000; and
- Health Savings Accounts (HSAs).

The written plan must specifically describe all benefits and establish rules for eligibility and elections.

Not only are cafeteria plan benefits available to any eligible employee who chooses to participate in the plan, they may be extended to spouses and dependents of employees. In addition, former employees can be covered, but the plan cannot exist primarily for these individuals (e.g., a retired business owner).

With this type of arrangement, employees can save both income tax and payroll tax.

**1. Income tax:** Usually, amounts are deducted from the paychecks of employees on a pre-tax basis under a salary reduction agreement. Salary reduction contributions are not actually or constructively received by the participant, so they are exempt from federal income tax.

**2. Payroll tax:** Most qualified benefits under a cafeteria plan are not subject to FICA, FUTA, Medicare tax or income tax withholding. However, group-term life insurance above $50,000 of coverage is subject to FICA and Medicare tax, although not FUTA or income tax withholding, even if it is provided as a qualified benefit in a cafeteria plan. Adoption assistance benefits are also subject to FICA and Medicare tax as well as FUTA, but not income tax withholding.

Finally, the plan must allow all employees who worked at least 1,000 hours in the previous year to participate. However, an employer may choose to exclude employees who are—

- Under age 21 before the close of the tax year; or
- Have been employed less than one year by the employer.

Otherwise, each eligible employee is free to select the fringe benefits they desire, subject to the usual tax law limits and requirements.

**Important:** Special rules and restrictions may apply to certain business owners, such as partners in a partnership or owner-shareholders of an S corporation, as well as sole proprietors. Obtain professional guidance concerning your situation.

## When You Strike It Rich
### Avoid some common missteps

Have you suddenly hit the jackpot? For instance, you may have won the lottery, inherited a large sum of money, pocketed lawsuit damages, sold your home at a large gain, received a big retirement plan payout or cashed in on a major stock market winner. In any event, you now possess considerably more wealth than you did before.

**Smart approach:** Do not follow some examples like prizefighters that have squandered a million dollar purse or heirs who have lost the family fortune in ill-advised schemes. For starters, you need a plan that follows sound money management principles. Here are several practical suggestions to keep in mind.

- Do not spend the money before you have it. All too often, a home sale that looks certain falls through, a huge jury award is reversed on appeal and so on. In other words, do not make any commitments you might regret before you actually have the cash in hand.

- Update your insurance. One of the first things you might do is adjust your insurance coverage to reflect your new-found wealth. For instance, an umbrella policy that adds to your automobile and home insurance can be used to protect you from personal liability.

- Put your money to work right away. For instance, you can place your funds in an interest-bearing account while you decide what to do next. Even if it earns a minimal amount, it is better than nothing.

- Avoid rash decisions. You might have the impulse to quit your job after you receive a windfall. However, it takes a substantial amount of investment income to replace a regular salary. For example, if you make $100,000 a year, it would take a $1 million windfall earning 10% annually to replace it. (These figures are purely hypothetical.) Likewise, do not rush out and buy a Rolls Royce or book a trip around the world without thinking things through.

- Pay attention to time limits. This is especially important if you are receiving a payout from a retirement plan. In essence, you have 60 days to decide whether to pay current tax on the distribution or defer it by rolling over the amount into an IRA. Consider all the ramifications.

- List your priorities. Your next move may depend on where the money is best served. Do you need to put away funds for a child's college or grad school education? Would you like to live in a bigger home? Have you saved enough for retirement? The answers to these questions can help point you in the right direction.

**Final advice:** Fortunately, you do not have to overcome all these obstacles on your own. If you suddenly strike it rich, you will likely face investment options, tax consequences, financial decisions and other complications you have not encountered before. It may be advantageous to rely on your trusted professional advisors.

## IRS to Go Paperless

In a new Fact Sheet (FS-2023-18, 8/8/23), the IRS has announced that it is close to going paperless.

The IRS still receives about **76 million paper tax returns** and forms and 125 million pieces of correspondence, notice responses and non-tax forms each year. It also has more than one billion historical documents, which costs $40 million per year to store.

Thanks to Inflation Reduction Act (IRA) resources, the agency has made significant strides adopting new technology for scanning paper returns. As part of the next phase, it is launching an ambitious plan to ensure that taxpayers will be able to go paperless by the 2024 tax filing season. By 2025, the IRS expects to achieve paperless processing that digitizes all paper-filed returns when received.

We will continue to monitor new developments.

**Facts and Figures**
**Timely points of particular interest**

**Knock, Knock**—To reduce public confusion and enhance overall safety the IRS has announced that it will end most unannounced visits to taxpayers. The change reverses a decades-long practice by the agency. Previously, IRS revenue officers sought to collect unpaid taxes and resolve account balances during such calls. Effective immediately, unannounced visits will cease (except in a few unique circumstances) and will be replaced with mailed letters to schedule meetings.