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Avoiding Underpayment Penalties

The IRS assesses penalties for underpayment of income tax. If you did not pay enough tax throughout the year, either through withholding or by making estimated tax payments, you may have to pay a penalty for underpayment of estimated tax.

What are the requirements to avoid penalties?

The required annual payment for most individuals is the LOWER of 90% of the tax shown on the current year's return or 100% of the tax shown on the return for the previous year. Certain high-income individuals must meet a more rigorous requirement. If the adjusted gross income on your previous year's return is over $150,000 (over $75,000 if you are married filing separately), you must pay the lower of 90% of the tax shown on the current year's return or 110% of the tax shown on the return for the previous year.

Can you provide some examples?

For example, if your total tax paid on the 2010 tax return was $10,000 and you are anticipating significantly higher income for 2011, the IRS is content as long as you pay in $10,000 via withholding or through even quarterly payments. The balance due on the 2011 tax return will need to be paid with the 2011 filing by April 15, 2012.

Should your income decrease significantly in the subsequent year, you would default to the 90% of tax shown on the current year return. By way of example, if you paid in $100,000 in tax for 2010, and you expect your income tax to be 50% less than it was in 2009, you would need to pay in 90% of $50,000 or $45,000 to avoid penalty. In this situation, we often recommend considering a tax projection to make sure you are adequately paid in.

What if I change from a salaried employee to self-employed?

This will require that you switch to quarterly estimate tax payments and adhere to the 90% current year tax or 100% of prior year tax rule as stated above.

What if I am a salaried employee and my withholdings are not adequate?

You would be subject to penalties if you do not update your W-4 kept on file by your employer. We recommend that you review and update your W-4 form. The W-4 form provides you the option to claim an additional set withholding amount over and above what they are taking. It is not uncommon to be filing Married 0 exemptions and still be short on your required payments due to other income circumstances, lack of deductions, etc. Your other alternative would be to pay in the difference via quarterly estimated tax payments.

What if your self-employment income is not steady throughout the year?

Most individuals make estimated tax payments in four installments. In other words, we determine the required annual payment, then divide that number by four and make four equal payments by the due dates. But you may be able to make smaller payments under the annualized income method. This method is useful to people whose income flow is not uniform over the year, perhaps because of a seasonal business. For example, if your income comes exclusively from a business that you operate in a resort area during June, July, and Aug., no estimated payment is required before Sept. 15. You may also want to use the annualized income method if a significant portion of your income comes from capital gains on the sale of securities which you sell at various times during the year.

Are there circumstances where the underpayment penalties do not apply?
The underpayment penalty doesn't apply to you:
1. if the total tax shown on your return is less than $1,000 after subtracting withholding tax paid;
2. if you were a U.S. citizen or resident for the entire preceding year, that year was 12 months, and you had no tax liability for that year;
3. if you are a farmer or fisherman and pay your entire estimated tax by Jan. 15 of the following year, or pay your entire estimated tax by Mar. 1 of the following year and also file your tax return by that date; or
4. for the fourth (Jan. 15) installment, if you aren't a farmer or fisherman, file your return by Jan. 31 of the following year, and pay your tax in full.

Will an extension buy me some time to pay my taxes?
No. An extension of time to file a tax return is NOT an extension of time to pay the tax due under the return. You must pay in 90% of the anticipated tax come extension time to avoid penalties.

How are the penalties and interest calculated?
The addition to tax is one-half of 1% of the tax not paid, for each month (or part of the month) it remains unpaid, up to a maximum of 25%. The penalty increases to 1% per month beginning with either the 10th day after notice of levy is given or the day on which notice and demand is made. Interest on underpayments of tax is imposed at the federal short-term rate plus three percentage points. These rates are adjusted quarterly.

In addition, IRS may waive the penalty if the failure was due to casualty, disaster, or other unusual circumstances and it would be inequitable or against good conscience to impose the penalty. The penalty can also be waived for reasonable cause during the first two years after you retire (after reaching age 62) or become disabled.

If you have any other specific questions about how the estimated tax and underpayment penalty rules apply to you, please do not hesitate to contact us.

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