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Planning Tax Payments to Avoid Penalties

Properly structuring tax payments requires careful planning, especially in light of tax reform

A cash windfall doesn't necessarily mean you have to immediately fork over the taxes, so control your cash as long as you can. And while the tax reform won't change the process, it will likely change the amount you eventually have to pay.

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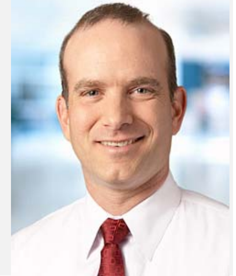

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An unusual spike in income – a large bonus from work, a gain on the sale of stock, etc. – typically brings two responses. The first is excitement over the windfall, but that's often quickly tempered by the second – uncertainty over the tax implications. While taxes shouldn't turn an otherwise positive experience into something negative, it's important to be aware of what the cost will be and, as importantly, when the taxes have to be paid.

The good news on the second part is that taxes often can be paid much later than expected. The IRS provides specific rules on when to pay a tax liability, and following those rules closely can provide taxpayers with the longest and best use of their income. In addition, the changes to tax law and the withholding tables for 2018 mean taxpayers should pay extra attention to their scheduled payments for this year to avoid an over-, or under-, payment.

IRS TAX PAYMENT REQUIREMENTS

In general, the best way to manage a tax liability is to pay as little of the tax during the year as needed to avoid a penalty, with the balance paid when the tax return is filed. There are two targets taxpayers can aim for in order to avoid a penalty, and they can use whichever one allows them to pay the least during the year:

1. Pay 90% of the current year liability.
2. Pay 100% of the prior year liability. If the taxpayer's Adjusted Gross Income for the prior year was more than $150,000, this target is increased to 110%.

As long as the taxpayer hits one of these two targets, the IRS will not assess an underpayment penalty, regardless of how much tax is ultimately paid at the tax return due date (typically April 15). Miss both targets, however, and the IRS will charge interest on the underpayment amount. The interest rate charged on those is reviewed quarterly, and is currently at 5% as of the second quarter of 2018. This is an annual interest rate but the penalty is calculated based on the number days of underpayment.

In both cases, taxpayers must include not just the income tax calculated on their tax return, but also things like Alternative Minimum Tax, self-employment tax, net investment income tax, etc. On the other hand, various tax credits – such as the foreign tax credit, child credit and the child care credit – can be used to reduce the targeted amount.

Basing current year tax payments on the prior year tax liability provides taxpayers with a specific target to hit. Because of this, this method is often referred to as the "safe harbor" method. In other words, it doesn't matter what's owed when the tax return is filed – as long as the payments during the year exceed the safe harbor amount there will be no penalty.

On the other hand, targeting 90% of the current year liability may mean a lower payment amount now, but it also requires carefully estimating the eventual tax cost. Because of this, some taxpayers will shoot a bit higher, aiming for 93-95% in order to provide some cushion for unexpected events.

- **Example 1a**: Taxpayer A had prior-year AGI of $135,000 and paid a total of $20,000 in tax. For the current year, they expect to have a total tax liability of $25,000. In order to avoid an underpayment penalty for the current year, they would need their payments for the year to hit the lesser of:
    - 100% of the prior year tax, or $20,000, because their prior year AGI was $150,000 or less.
    - 90% of the current year tax, or $22,500 ($25,000 x .9).

  They will target paying $20,000 during the current year, and will then pay the remaining $5,000 of their current year liability when they file their tax return April 15.

- **Example 2**: Taxpayer B had prior-year AGI of $170,000 and paid a total of $26,000 in tax. For the current year, they expect to have a total tax liability of $27,000. In this case, they would they would need their payments for the year to hit the lesser of:
    - 110% of their prior year tax, or $28,600 ($26,000 x 1.1), because their prior year AGI was more than $150,000.
    - 90% of the current year tax, or $24,300 ($27,000 x .9).

  They will target paying $24,300 during the current year, and will then pay the remaining $2,700 of their current year liability when they file their tax return April 15.

While taxpayers have some flexibility in calculating the required payments during the year, there isn't much flexibility when it comes to when those payments must be made. Taxpayers typically can't wait to make all their tax payments at the end of the year. Instead, the targeted amount must be met on a quarterly basis or else the taxpayer is considered underpaid until they make enough subsequent payments to "catch up". The required payment to avoid a penalty each quarter is simply ¼ of the total requirement for the year, but the payment deadlines don't correspond to actual calendar quarters. Payments are due after the end of each "quarter" with deadlines of April 15, June 15, September 15 and January 15. Those deadlines are pushed out if any of them fall on a weekend or holiday.

- **Example 1b**: In Example 1a above, the taxpayer's target payment is $20,000, meaning they must pay $5,000 per quarter to avoid an underpayment penalty. If this taxpayer made no payments as of April 15 of the current year, they would be considered underpaid for the first quarter. If the taxpayer then made a payment of $10,000 June 15, their payments would be caught up as of the second quarter. However, they would still be penalized for the two months (from April 15 to June 15) during which they were underpaid.

WITHHOLDING AND ESTIMATED TAX PAYMENTS

Individuals who are working are required to have income taxes withheld directly from their salary. Taxpayers who have little to no income other than their salary usually find their withholding is more than enough to cover their targeted tax payment, and they often end up with a refund when they complete their tax return. The exception to that might be those with larger bonuses, stock option income, etc., where a flat percentage is withheld that may be less than the actual tax rate applied to that income.

Those who have income that is not required to be withheld on – such as investment income, business income or retirement distributions – may find they need to make additional tax payments throughout the year. These payments are calculated by the taxpayer and delivered to the IRS along with a payment voucher, Form 1040-ES. These estimated payments are due on the quarterly deadlines, and late payments of those may result in a penalty being assessed until the payment is received by the IRS. Taxpayers who find they missed a payment deadline should not wait until the next payment due date to catch up. The underpayment penalty is calculated on a daily basis, so the sooner the payment is made, the sooner the penalty stops.

For taxpayers whose only income is from a business or investments, where withholding is not typically available, estimated payments are likely the only option for paying their taxes. Taxpayers who have a combination of income that is withheld on and other income not subject to withholding, or retirees whose income consists of pension payments and IRA withdrawals, can typically choose how to cover the tax liability on that other income. As usual, there are pros and cons to each approach:

- By paying the tax on that additional income via estimated payments, the taxpayer can keep control of the income for a longer period of time. They might earn the income in the beginning of the year, but only make the estimated payments on each quarterly due date. However, this requires the taxpayer to be aware of the deadlines and be sure to send their payments on time. It also means they must be careful to set aside some of their income periodically to cover the tax cost, rather than spending or reinvesting it.
- Depending on the amount of non-salary income, a taxpayer could simply increase the withholding on their salary to cover the tax cost of this other income. Doing so relieves the fear of missing the payment deadline, but also means the taxes may be paid perhaps months before the estimated payment would be due.

PLANNING AROUND AN UNEXPECTED INCREASE IN INCOME

For taxpayers whose income comes almost exclusively from wages that are subject to withholding, their withholding is usually more than enough to cover 90% of that year's taxes. But what happens when that taxpayer experiences an unusual increase in their income, perhaps by realizing a large capital gain from an investment? In that case, the taxpayer can often wait to pay the tax on that income until the April 15 due date for their tax return.

- **Example 3a**: A married couple only has income from their respective jobs, all of which is subject to withholding. They expect their tax liability for the year to be $50,000, the same as it was for the prior year, but their withholding is projected to be $56,000. They then realize a large gain on the sale of an investment that will increase their current year tax liability to $65,000.

The couple in this example was on pace to well exceed the 90% of current year liability threshold, but the capital gain has increased that 90% target to $58,500 ($65,000 x .9), more than their projected withholding for the year. They now have the following options:

1. Increase the withholding on their wages to bring their payments to at least $58,500.
2. Make a separate estimated payment to get them to the $58,500 target.
3. Do nothing. Their projected withholding of $56,000 will exceed 110% of their prior year tax liability ($50,000 x 1.1, or $55,000), so they will meet the safe harbor target for the current year.

This couple would chose option 3. By exceeding the safe harbor target, they're assured of avoiding a penalty, so they might as well wait to pay any additional tax until they file their tax return the next April 15. This allows them to keep the use of their money for the longest time period. Their projected withholding of $56,000 will be short of their eventual $65,000 tax liability, so they should be sure to set aside $9,000 of the proceeds from the sale to pay that tax cost.

In the year following an unusual increase in income, the tax planning becomes more important.

- **Example 3b**: In the year following their big capital gain, the couple in the previous example returns to their typical income level, and again expect their withholding to be $56,000. After reinvesting the proceeds of their gain, however, they have additional investment income and project their tax liability to again reach $65,000.

In this case, their projected withholding of $56,000 will not reach either 90% of the current year tax ($65,000 x .9, or $58,500) or 110% of their prior year tax ($65,000 x 1.1, or $71,500). This couple will need to increase their payments during the year somehow to make up the difference – either by increasing the withholding on their wages or by making estimated tax payments. They will target 90% of the current year liability as it's the smaller amount and won't result in a large overpayment for the year.

OTHER PLANNING TIPS AROUND TAX PAYMENTS

- Another technique that can be used to reduce the risk of an underpayment penalty is called Annualized Income, and it's especially helpful for those who use estimated payments to pay their taxes during the year. This allows a taxpayer to project their current year tax liability based on their actual income and deductions as of each payment due date, and then pay the appropriate percentage of that tax for that quarter. For taxpayers whose income tends to come at the end of the year, this allows them to delay their tax payments until the income is actually received. This would include business owners whose income back-loaded to the year, retirees who wait to take their Required Minimum Distributions or investors who realize gains at year-end.
- Taxpayers who find themselves behind on tax payments during the year may find it's better to increase withholding rather than make an estimated payment. The IRS considers any tax withholding as occurring evenly throughout the year, whereas estimated payments are credited on the date they're made. If a taxpayer is underpaid for the first few quarters of the year, they can increase their withholding over the last few months and the IRS will assume those payments were made evenly during the year rather than back-loaded at the end of the year. Retirees who choose to take IRA distributions at year end may decide to have much of the distribution withheld for taxes. Those taxes will be assumed to have been paid throughout the year, even though they were actually paid much later.
- These explanations and examples are all based on federal tax law, but states often follow these same rules as well. This is not universal, however, so be sure to check with the particular state.

Lastly, in order to maintain the best and longest use of their cash flow, taxpayers should plan to owe money with their tax return each year rather than get a refund. Tax refunds are simply interest-free loans to the government, and most taxpayers would prefer to have access to their money sooner than later. Yes, tax refunds can be a form of forced savings, and those whose income is primarily from wages that are withheld on may not have the ability to reduce their withholding enough to avoid a refund. The IRS estimates that of the over 152 million tax returns filed during 2017, nearly 75% resulted in a tax refund, with an average refund around $3,000.[1] However, good cash management practices would tell you that it's best to keep your money yourself and wait to pay your tax liability closer to when it's actually due.

SPECIAL CONSIDERATIONS FOR 2018

The tax reform act passed in late 2017 (the Tax Cuts & Jobs Act) included many significant changes that take effect in 2018 and will impact all taxpayers. Taxpayers will want to take these changes into account when planning their 2018 tax payments. Some of the more impactful changes included in this tax reform are:

- New limitations on many of the deductions taxpayers have claimed in the past.
- A new exclusion for income received from a pass-through business.
- Significant changes that will limit the impact of the Alternative Minimum Tax.
- Lower tax rates applied to virtually all levels of income.
- Changes affecting families, including the repeal of the personal exemption along with the expansion of the existing child credits.

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[1] 2017 Filing Season Statistics, Internal Revenue Service, January 12, 2018, https://www.irs.gov/newsroom/filing-season-statistics-for-week-ending-december-29-2017.

The combination of these will have most taxpayers reporting a higher level of taxable income in 2018 but a lower total tax liability, assuming income and deductions are consistent. The Tax Policy Center, which provides independent analysis of various tax issues, has published a study on the impact of these changes that concluded[2]:

- 80% of taxpayers will receive a tax cut in 2018, averaging about $2,100
- 5% of taxpayers will face an average tax increase in 2018 of about $2,800

Taxpayers who base their 2018 tax payments on their 2017 income tax liability may find themselves exceeding their required payment to avoid a penalty – and possibly even ending up in a tax refund position. Instead, taxpayers will want to estimate their 2018 tax liability to see if it makes sense to base their payments on this year's tax.

The IRS has created a new calculator that can be used to project a 2018 tax liability and compare this to projected income tax withholding. This calculator can be found at www.irs.gov/individuals/irs-withholding-calculator. A few key points in using this tool:

- This calculator will assist in completing a new Form W-4 for those whose projected withholding will not cover their entire projected 2018 tax liability. It is targeting the entire liability, not just the amount needed to avoid an underpayment penalty, so it could result in paying more than necessary during the year but avoiding a payment when the tax return is filed.
- This calculator does not take into consideration the lower tax rate that applies to long-term capital gains and qualified dividends. Taxpayers with this type of income will find their 2018 tax cost overstated with this calculator.
- Business owners benefiting from the new 20% exclusion will need to adjust the income they enter in this calculator to account for this exclusion.

Taxpayers who use commercially-available software to prepare their 2017 tax return may have also generated 2018 estimated tax payment vouchers. Their software likely generated those in order to help the taxpayer exceed the safe harbor amount for 2018, but with these tax law changes that target may no longer be the best option. Before submitting payments with those vouchers, taxpayers should review their projected 2018 tax liability to ensure that safe harbor target is still appropriate.

[2] Distributional Analysis of the Conference Agreement for the Tax Cuts and Jobs Act, Tax Policy Center, December 18, 2017, http://www.taxpolicycenter.org/publications/distributional-analysis-conference-agreement-tax-cuts-and-jobs-act/full.