Successfully Navigating Estimated Payments to a Safe Harbor to Avoid the Dreaded Underpayment Penalty

Another tax season has come and gone, and (hopefully!) you got your return filed on time. Did you wind up having to write a big check to the government, making you wonder "Why do I still owe taxes?" We can help answer that question: https://www.krilogy.com/why-do-i-still-owe-taxes/

Or maybe your tax preparer gave you vouchers and instructions to make estimated tax payments for next year's tax return, and you're unclear about **why** you have to make estimated tax payments, or do you even **need** to? Just what are estimated tax payments, anyway?

Quite simply, the United States operates on a "pay-as-you-go" income tax system; as a taxpayer earns or receives income throughout the year, they are generally required to pay the tax liability on the income as it is earned. One quick example of this is a W-2 employee has a portion of each paycheck withheld from their federal (and sometimes state) tax liability – every time they get paid. However, several sources of income are not subject to withholding: interest income, dividends, capital gains, and self-employment income are just a few examples. If a taxpayer doesn't make payments to the government as they are realizing this income, they could be liable for an underpayment of estimated tax penalty. Thankfully, taxpayers are not expected to mail a check every time they receive this income; instead, the tax year has been broken down into four quarters in which to make these estimated payments. These payments are generally due April 15 (Q1), June 15 (Q2), September 15 (Q3), and January 15 of the following year (Q4), but if the due date falls on a weekend or holiday these payment due dates move to the next business day. It is important to note that if you do not pay these payments on time and for the appropriate amount you could still be subject to underpayment of estimated tax penalty.

But how much should these estimated payments be? Do you (or your tax advisor) have to calculate your total income and tax liability each quarter to make an accurate estimated payment based on what you would have owed that quarter? You can; that's called the "**Annualized Income Installment Method**," but it's a bit like having to prepare a tax return each quarter, and one tax return a year is plenty. While the Annualized Income Installment Method can be useful in specific circumstances (such as big swings in income throughout the year), two other simpler "safe harbor" methods exist to remove the complexity of having to calculate your tax liability each quarter and eliminate any underpayment penalty.

Using the Prior Year's Tax Liability

The simpler safe harbor method of calculating estimated tax payments bases your payment amounts on last year's tax liability: taxpayers with an Adjusted Gross Income up to $150,000 (or $75,000 for married filing separately) must pay 100% of the prior year's total tax liability in four equal installments, and taxpayers with an AGI above $150,000 (or $75,000 for married filing separately) must pay 110% of the prior year's total tax liability in four equal installments. As long as the taxpayer has made these payments, no matter what their final tax liability is, the safe harbor protects the taxpayer from an underpayment penalty.

Using the Current Year's Tax Liability

While using the prior year's tax liability is simple and straightforward, it doesn't make sense in all circumstances. Some examples where it may not make sense to use the prior year's tax liability would be when taxpayers are expecting a significant drop in income from the prior year. Taxpayers would not want to tie up free cash-paying estimates that are just too large for what they'll owe this year. In that instance, the second safe harbor method might be more intriguing: taxpayers who pay 90% of the *current year's* tax liability in installments throughout the year based on income received should be protected from estimated tax penalties. Estimating your current year's liability as the tax year is in progress may be a little more complex than simply taking last year's tax liability and dividing it by four, but it can help you from making needlessly excessive estimated tax payments.

States have their own Safe Harbor

One thing to note is that the above safe harbor methods are the rules according to the IRS, and each state may have a different method for calculating safe harbor. For example, Missouri allows taxpayers to annualize tax estimates, or allows safe harbor by paying either 100% of the prior year's tax or 90% of the current year's tax as the IRS does, but also has exceptions for calculating what the prior year's tax liability would have been using the current year's rates and exemptions and paying estimates at 100%, accordingly. Interestingly, Missouri allows taxpayers to switch methods for each quarter's payment.

Using retirement accounts as sources of estimated tax withholding

Earlier, we used the example of a wage employee having a portion of every paycheck withheld to satisfy the pay-as-you-go nature of our tax system; one avenue to avoid having to make estimated tax payments is to increase paycheck withholding to reach that safe harbor target. However, wages aren't the only income that can be withheld from. Pensions and retirement accounts offer the opportunity for withholding and can offer a decided advantage over making estimated tax payments each quarter. Thanks to the Internal Revenue Code [Section 6654(g)(1)], withholdings are considered to be evenly spread

throughout the year, regardless of what point in the year they were actually withheld. This means that, should a taxpayer make it to December underpaid on estimated tax, they are able to take an IRA distribution and withhold the underpaid estimated tax to make the catch-up tax payment considered as if it was paid over the course of the year, which could help eliminate the underpayment penalty. If that taxpayer would have instead just written a check in December to make an estimated tax payment, there would still be an estimated tax penalty for the portion of the year the taxpayer was underpaid.

But what if the taxpayer is too young to take an IRA distribution without penalty, or doesn't want the added tax liability from an otherwise unneeded IRA distribution?

Erase-and-Replace Strategy

At Krilogy Tax, we utilize several tools in our toolbox to reduce your tax liability and maximize the potential for your investment dollars to be put to work, but perhaps none are more illustrative of the benefits of having a savvy tax advisor working in close coordination with your investment advisor than the "erase-and-replace" strategy. This is a two-step process that allows a taxpayer to use an IRA to correct the problem of having underpaid estimates and also eliminate any tax liability related to the distribution from the retirement account.

In the last scenario, the under-withheld taxpayer was able to make an IRA distribution to "catch up" their estimated tax payments because the withholding is considered evenly spread throughout the year. However, now the taxpayer has to pay tax on the IRA distribution – and perhaps also a 10% penalty if they are less than 59.5 years old. There **is** a quick fix! Provided it wouldn't violate the once-per-year rollover rule for IRAs, the taxpayer can take the non-retirement account funds that normally would have been used to make the (late) estimated tax payment and roll that into a retirement account within 60 days, making this an indirect rollover. By completing a rollover, the retirement funds that were used to make the tax payment will have been replaced, and the tax liability (and possible penalty!) from the distribution will be erased – but the tax payment made via withholding will still be in place – and considered timely made throughout the year, eliminating the underpayment penalty.

Bear in mind, this particular strategy might not be advantageous in all circumstances or applicable to every taxpayer; as this strategy might not be worth the time and effort if the underpayment penalty would be minor. However, we highlight it to show the importance of having your tax advisor working closely with your investment advisor. Sometimes your personal tax situation can seem like a ship tossed about a stormy sea; the Krilogy Tax team is ready to help you steer your ship to a safe harbor.

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