Avoiding IRS Underpayment Penalties

Article Highlights:

- Pay-as-you-go System
- Safe Harbor Payments
- Situations Triggering Underpayments
- True Safe Harbors

Congress considers our tax system as a "pay-as-you-go" system. To facilitate that concept, the government has provided several means of assisting taxpayers in meeting the "pay-as-you-go" requirement. These include:

- Payroll withholding for employers;
- Pension withholding for retirees; and
- Estimated tax payments for self-employed individuals and those with other sources of income not covered by withholding.

When a taxpayer fails to prepay a safe harbor (minimum) amount, he or she can be subject to the underpayment penalty. This nondeductible interest penalty is higher than what might be earned from a bank and is computed on a quarter-by-quarter basis.

Federal law and most states have safe harbor rules. There are two Federal safe harbor amounts that apply when the payments are made evenly throughout the year.

1. The first safe harbor is based on the tax owed in the current year. If your payments equal or exceed **90% of your current year's tax liability**, you can escape a penalty.
2. The second safe harbor – and the one taxpayers rely on most often – is based on your tax in the immediately preceding tax year. If your current year's payments equal or exceed **100% of the amount of your prior year's tax**, you can escape a penalty. If your prior year's adjusted gross income was more than $150,000 ($75,000 if you file married separate status), then your payments for the current year must be 110% of the prior year's tax to meet the safe harbor amount.

Where taxpayers get into trouble is when their income goes up or their withholding goes down for the current year versus the prior year. Examples are having a substantial increase in income, such as when investments are cashed in, thereby increasing income but without any corresponding withholding or estimated payments. Another frequently encountered situation is when a taxpayer retires and his payroll income is replaced with pension and Social Security income without adequate withholding. Taxpayers who don't recognize these types of situations often find themselves substantially underpaid and subject to the underpayment penalty when tax time comes around.

Bottom line, **100%** (or **110%** for upper-income taxpayers) **of your prior year's total tax** is the only true safe harbor because it is based on the prior year's tax (a known amount), whereas the 90% of the current year's tax amount is a variable based on the income for the current year, and often that amount isn't determined until it is too late to adjust the prepayment amounts.

Please contact this office promptly if you have a substantial increase in income, so that withholding or estimated tax payments can be adjusted to avoid a penalty.