TAX REPORT

A Surging IRS Penalty Is Costing Americans Billions. Here's How to Avoid It.

Estimated-tax penalties can catch taxpayers by surprise. Even the government's 'safe harbors' aren't entirely safe.

By Laura Saunders Follow

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Here's a wake-up call for millions of Americans who pay some or all their income taxes quarterly rather than through paycheck withholding: Penalties on underpayments of these taxes have surged recently. Second-quarter amounts are due June 17, so affected taxpayers need to act right away.

This group includes many investors, retirees, business owners and gig workers who aren't employees, and some others who are. For example, two-earner couples or staffers with stock options could also owe penalties if they aren't withholding enough.

"These charges can hit hard, so getting it right can save people hundreds or even thousands of dollars a year," says Richard Pon, a CPA in San Francisco with many clients who pay quarterly.

The average estimated-tax penalty in fiscal-year 2023 climbed to about $500 from about $150 in 2022, according to Internal Revenue Service data. Meanwhile the number of affected tax filers rose to 14 million from 12 million. Overall, the agency assessed $7 billion in estimated-tax penalties in 2023, nearly four times the $1.8 billion it assessed in 2022.

A key reason for the increase is higher interest rates, according to an IRS spokesman, although the total ups.

To see why rates matter, remember that ever since Congress expanded the income tax during World War II, employees have had to pay most of their income tax through paycheck withholding or face penalties. To prevent gaming of the system by non-employees, the law requires filers with other taxable income—such as from investments or self-employment—to make estimated tax payments each quarter.

Filers who don't pay in enough tax throughout the year owe a penalty in the form of an interest charge on their underpayment that's set quarterly. In 2021, the year that prompted most of the 2022 assessments, the IRS's rate on underpayments was a rock-bottom 3%. The penalty is based on the short-term Treasury rate plus three points, and it climbed to 6% as rates rose in 2022. That pushed up charges on underpayments assessed the next year.

In 2023 the rate rose to 8% for the fourth quarter. It's still there–so underpayment penalties will continue to sting taxpayers who owe them.

One filer already on the alert for 2024 is George Young, a retired actuary living in Falmouth, Maine. He was surprised when his tax-prep program showed $166 for estimated-tax penalties for 2023, although he had made large payments to avoid them.

Now he thinks part of the penalty came from timing mismatches, as he received investment income throughout the year but didn't make estimated tax payments until the fourth quarter. "I'll be trying for a better alignment this year," he says.

The bad news for taxpayers trying to avoid underpayment penalties is that they're complex. The good news is it's often possible to sidestep them by making savvy use of the tax rules. Here's what to know.

Taxpayers who owe $1,000 or more normally must pay 90% of their tax bill long before the April 15 due date. For employees the deadline is yearend, and for those with other taxable income, the deadline is when fourth-quarter payments are due–typically Jan. 15.

If taxpayers don't pay the 90% and aren't protected by so-called safe harbors described below, they can owe a penalty that's an interest charge on the underpayment. The rate is set and published quarterly by the IRS; currently it's 8%.

Making a payment to the IRS at any point can reduce this interest–so filers facing these charges can save by making payments before their April 15 due date.

The danger of safe harbors

Many taxpayers are aware of safe harbors that protect against estimated-tax penalties. They're available to filers who pay the IRS 100% of their prior-year tax by the yearend or Jan. 15 deadline if their adjusted gross income is $150,000 or less. Taxpayers earning more must pay 110% of the prior-year tax to qualify.

Beware: These safe harbors apply *per quarter*, not per year. So if someone has income in the second quarter but doesn't pay the safe-harbor amount until the third or fourth quarter, underpayment penalties could apply.

Circumventing the IRS computers

The IRS's computers can impose undeserved penalties on some estimated-tax filers, because they automatically treat income as though it's earned equally throughout the year. So if a filer does a fourth-quarter Roth IRA conversion and pays tax on it at that time, the system will assume the income was earned all through the year but the tax was only paid in the fourth quarter.

The way to tackle this dilemma is to file IRS Form 2210 and Schedule AI, which tells the IRS in what quarters income was earned and taxes were paid. DIY filers with uneven income should check whether their software can handle both forms, as some programs can't.

retired after reaching age 62 or became disabled, and it will also waive penalties for others who show reasonable cause. To request a waiver, file an abbreviated Form 2210 using the form's instructions.

How withholding can save you

Many taxpayers–especially retirees–have income that qualifies for withholding when it's paid as well as income subject to estimated taxes. Pensions, withdrawals from traditional IRAs and similar retirement plans, Social Security payments, and bonuses all qualify for withholding. For more information, see IRS Publication 505.

This income has a terrific benefit: The law considers withholding on it to have come in evenly throughout the year–no matter when it actually was paid.

So if an investor owes $5,000 of tax on investment income for the first quarter and then withholds an extra $5,000 on a December IRA withdrawal that covers the tax, that could avoid an estimated-tax penalty on the first-quarter income. For this reason, retiree Young says he plans to raise his withholding on retirement income this year.

While it might be hard for pension payers or Social Security to move quickly on changes to withholding, it's often easier for IRA custodians. Fidelity Investments, for example, allows IRA owners to set the tax withholding for each withdrawal.

Don't forget state taxes

States often have penalties on underpayments of estimated income taxes. If your state is one, beware of rising interest rates and find out where you stand.

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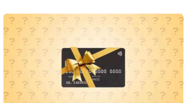

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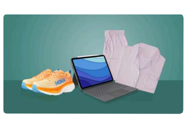

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