Estimated Income Tax Underpayments

Quick take:

Given the high interest rate environment, the IRS currently charges an interest rate of 8% on estimated tax underpayments. All taxpayers are susceptible to this penalty and should be cognizant of their estimated tax payments.

For individual taxpayers, the federal income tax is a "pay-as-you-go" regime. This means that taxes are generally owed as you earn your income throughout the year. If a taxpayer fails to withhold sufficient taxes or make quarterly estimated tax payments, he or she may be subject to interest and penalties. As interest rates have risen, the interest charged by the IRS has increased and is now 8%. This higher interest rate can lead to surprise taxes when clients file their taxes in April.

Taxpayers can typically shelter themselves from underpayment penalties by following the safe harbor rules for estimated payments. This directs individual taxpayers to withhold at least 90% of the current-year tax liability or 110% of the previous year's tax liability (100% of previous year liability if your Adjusted Gross Income is less than $150,000 and filing Married Filing Jointly) by January 15 following the close of the tax year, with the safe harbor amount having been met on a quarterly basis.

Estimated Tax Payment Schedule for Individuals:

Quarter	Income Period	Due Date
Quarter 1	January 1 – March 31	April 15
Quarter 2	April 1 – May 31	June 15
Quarter 3	June 1 – August 31	September 15
Quarter 4	September 1 – December 31	January 15

Avoiding Missed Estimated Payments:

- Ensure that you are withholding enough tax or making your quarterly estimated tax payments in a timely manner. Discussing tax projections with your tax preparer on an annual basis is the best way to avoid interest and penalties when you file your taxes. Reviewing tax projections is also helpful from a cash flow planning perspective.

- Be aware that "Supplemental Income" (bonuses, equity awards, commissions, etc.) is commonly withheld at 22%. Individuals frequently set their withholding amounts using a W4 based upon their own family size and income level and assume that this will satisfy their tax obligations. If a large portion of their income is derived from Supplemental Income sources withheld at 22%, it is possible that estimated payments will be required.

- Withholding (through your employer or IRA / 401(k) distributions) is assumed to have been paid in 25% each quarter. If you have missed an estimated tax payment, you may limit your liability by increasing withholding through wages or through an IRA distribution to "retroactively" satisfy your quarterly payment requirements.

- Income and withholding are generally considered to be earned evenly throughout the year. If your income tends to be higher toward year-end, or your withholding is larger in the beginning of the year, speak with your tax preparer about "annualizing" your withholding or income to limit your estimated payment liability. As previously mentioned, reviewing a tax projection with your tax preparer can help plan your tax payment responsibilities throughout the year.