HOW TO AVOID TAX UNDERPAYMENT PENALTIES

U.S. income tax is basically pay as you go. As you earn income during the year, you’re expected to pay your taxes on it – or you’ll be penalized.

There are basically two ways to pay your taxes – through withholding from your paycheck or by making estimated payments for those who don’t receive regular paychecks on the income they earn.

If you do not pay enough tax throughout the year, penalties may apply. But with proper planning, the penalties are avoidable.

You won’t be penalized if you owe less than $1,000 in taxes after subtracting withholding and credits. You also won’t be penalized if you pay at least 90 percent of the tax you owe for the current year, or 100 percent of the tax shown on your tax return from the prior year.

If adjusted gross income for 2013 was more $150,000 for married taxpayers, 100 percent of the tax owed must be paid or there will be a penalty.

There are special rules for farmers and fishermen. If two-thirds of income comes from farming or fishing, there are penalties only if you haven’t paid at least 66 2/3 percent of the tax owed. There are also special rules for certain household employers and certain higher income taxpayers. Check in IRS Publication 505, Tax Withholding and Estimated Tax, to see if any of the special rules apply to your situation.

In general, your estimated tax payments should be made in four equal amounts to avoid a penalty, according to the IRS. But if your income is received unevenly during the year, annualizing your payments and making unequal payments may be able to eliminate or lower your penalty. Check IRS Form 2210, Underpayment of Estimated Tax by Individuals, Estates and Trusts, to see if you owe a penalty.

If it appears that you will be subject to an underpayment penalty, you may be able to reduce or eliminate the penalty by initiating or increasing your quarterly estimated tax payments.

A quirk in the penalty rules treats withheld taxes – even withholding that occurs late in the year – as if they had been taken evenly throughout the year. So, if you’re employed, instructing your employer to withhold more from your pay can even eliminate penalties that accrued earlier in the year.

While most people want to avoid unnecessary penalties, it is seldom a good idea to pay more than the law requires or to pay your taxes earlier than necessary. Why let the government hold your money only to return it to you next year as a tax refund – with no interest?
Your goal should be to pay just enough to avoid an underpayment penalty but not so much as to create a large refund. If it looks as if you have been paying too much tax, cut back on your withholding or lower your remaining quarterly estimated tax payments.