Diversified Accounting Services

Dear Client:

The United States has a "pay as you go" tax system in which payments for income tax (and, where applicable, Social Security and Medicare taxes) must be made to the IRS throughout the year as income is earned, whether through withholding, by making estimated tax payments, or both.

You suffer an estimated tax penalty if you don't pay enough to the IRS during the year.

The IRS levies this non-deductible interest penalty on the amount you underpaid each quarter. The penalty rate equals the short-term interest rate plus three percentage points.

Due to the rise in interest rates, the current penalty rate is 8 percent—the highest in 17 years. And since it's not deductible, the net cost likely far exceeds 8 percent.

If you're an employee and have all the tax you owe withheld by your employer, you don't have to worry about this penalty.

But you must worry about it if you're self-employed because no one withholds taxes from your business income. Likewise, you must worry if you receive income from which no, or not enough, tax is withheld—for example, retirement distributions, dividends, interest, capital gains, rents, and royalties.

C corporations are also subject to the underpayment of estimated tax penalty.

Fortunately, it's easy to avoid this penalty!

- All individual taxpayers have to do is pay (1) 90 percent of the total tax due for the current year or (2) 100 percent of the total tax paid the previous year (110 percent for higher-income taxpayers with adjusted gross incomes of more than $150,000 ($75,000 for married couples filing separately).
- Corporations must pay 100 percent of the tax shown on their return for the current or preceding year (but large corporations can't use the prior year).

Most individuals and corporations make *equal* quarterly estimated tax payments to the IRS. The IRS applies the penalty separately for each payment period. Thus, you can't reduce the penalty for one period by increasing your estimated tax payments for a later period. This is true even if you're due a refund when you file your tax return.

Some individuals and corporations can use alternate methods for computing estimated taxes, such as the annualized income method. But the alternate methods can be complicated.

If you want to discuss your estimated taxes, please call us at 973-433-0103.

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