THE ULTIMATE GUIDE TO UNDERPAYMENT PENALTIES

Filing your tax return may seem easy, but it'll get a whole lot stressful when you see that you've been hit with an underpayment penalty. This happens when you didn't pay enough tax throughout the year. However, there are instances when you can avoid this penalty, and there are things you can do to make sure this doesn't happen to you. An underpayment penalty can cause you a lot of headaches and inconveniences. Solve and avoid your penalty woes with this guide!

What Is An Underpayment and Underpayment Penalty?

- In the US, individuals and corporations earning income must pay taxes.
  - Employees' withholding taxes are deducted from their salaries by their employers.
  - Self-employed and independent contractors pay quarterly estimated taxes.
- Paying only a portion of your withholding or estimated taxes throughout the tax year is called **underpayment of estimated tax**.
  - The IRS will assess your underpayment penalty.
- Prize winnings, profits from stocks and other investments, and any alimony received are also considered as taxable income.
  - The IRS expects you to report them on your tax return for the year they are given.
  - Not paying enough taxes for your other sources of income will also incur underpayment penalties.

Why An Underpayment Happens?

- **Income Taxes**
  - All employers withhold federal taxes (plus state and local taxes, if applicable) from the employees' wages, except in cases of qualified tax exemption.
  - Employers can miscalculate if they do not follow the IRS withholding tax tables and the employees' withholding allowance stated in their Form W-4.
    - An employee might claim the wrong number of allowances resulting in underpayment.
  - An employer can also underwithhold taxes if he is not updated on new tax rules and rates.
- **Quarterly Estimated Taxes**
  - Self-employed, independent contractors and part-time workers are required to pay estimated taxes because withholding taxes are not taken out of their income.
  - To get your estimated tax liability, divide the amount you paid last year by four.
    - If you think your income will decrease from the previous year, then base your calculations from your earnings during the current year.
  - Payments are due four times a year:
    - April 15 for January 1 to March 31
    - June 15 for April 1 to May 31
    - September 15 for June 1 to August 31
    - January 15 of the following year for September 1 to December 31
  - Self-employed individuals might miscalculate their tax liability leading to underpayment.
  - Small businesses inadvertently misclassify employees, miscalculate wages, or neglect proper record keeping that may result in errors in calculation.
  - Lack of funds can also result in an underpayment.

How Much Is The Penalty For Underpayment?

- Use the Form 2210 to see if you owe a penalty for tax underpayment. This will help you calculate the amount of taxes you owe by subtracting the amount already paid in estimated taxes throughout the year.
- If you have underpaid, you have to pay the difference plus a potential penalty. The calculation is based on the outstanding amount owed as well as how long it has been overdue. Usually, the penalty is 0.5% of the amount owed for each unpaid month.
- The percentage will increase per month, but it will not exceed 25% of the unpaid taxes you owe. If you have an installment agreement, the monthly percentage will decrease to 0.25%
- The penalty may also be subjected to interest rates. For taxpayers that are not corporations, the underpayment and overpayment rate is the federal short-term rate plus 3 percentage points.
- The penalty is based upon the lesser of these two amounts:
  - 100% of the tax you paid for the previous year; or
  - 90% of the tax you will pay in total for the year
- Fishermen and farmers will use 66 2/3% of the tax they'll pay instead of 90%.
- For taxpayers who are not fishermen and farmers, and whose income is greater than $150,000 or $75,000 for Married Filing Separately, the factor to be used is 110% of the amount of tax paid the previous year, rather than 100%.

How To Avoid The Underpayment Penalty?

- Generally, you can avoid underpayment penalty under these 3 scenarios:
    - You owe less than $1,000 in taxes after subtracting your withholdings and estimated tax payments
    - You had no tax liability the previous year
    - You paid at least 90% of the tax you owed for the current year or 100% of what you paid in taxes the previous year -- whichever is smaller
- **PENALTY WAIVER -** You may request this due to one of the following conditions:
    - You were not able to make a required payment due to:
        - Casualty disaster, event, or other unusual circumstance and it would be inequitable to impose the penalty
        - You retired (after reaching age 62) or became disabled during the tax year or in the preceding tax year for which you should have made estimated payments, and the underpayment was due to reasonable cause and not willful neglect
- **ANNUALIZED INSTALLMENT METHOD -** you can use the annualized installment method at tax-time to reflect your fluctuating income.
    - If your earnings and other taxable income came in unevenly over the year, the annualized income installment method might reduce or wipe away the underpayment penalty.
- **ASK FORGIVENESS -** The IRS can waive penalties for first-time offenders but you have to request it.
    - To qualify for "first-time abatement," you must have no tax penalties for the previous three tax years, all required returns filed, and have paid—or arranged to pay—any tax due.

For tips, resources and expert advice on managing your taxes effectively, visit help.taxreliefcenter.org

Sources:

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