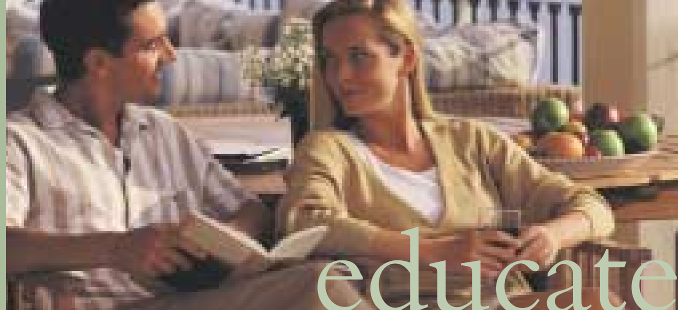

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Decreasing Income—When a taxpayer's income decreases and their tax liability will be less, they probably will not want to make payments based on the "Prior Year Exceptions" since that would require them to overpay their estimated taxes. To avoid penalties, they will need to prepay 90% of their liability (current year exception) for the year or have a balance due not exceeding $1,000 (de minimis exception).

Fluctuating Income—Where a taxpayer's income fluctuates significantly in different quarters of the year, they may not have the cash available to make even payments and will need to base their estimates on the income received during each quarter. These individuals can avoid a penalty by using the "Annualized Income Exception." This requires the taxpayer to project their annual income and resulting tax based upon the income they have received through the current quarter. They prorate the annual tax through the current quarter and pay the prorated amount less the amount previously paid for the year.

Withholding Plus Estimates—Frequently, prepayments consist of both withholding and estimated payments. While estimated tax payments are in the control of the taxpayer, withholding is not and may fluctuate during the year. As a result, the withholding may be less than the amount needed to meet one of the exceptions. The exceptions to the penalty provide no latitude for unforeseen withholding changes.

Allocating Estimates Between Spouses and Ex-spouses

If you and your spouse are married on the last day of the tax year but file separate returns, the following rules are used to determine who gets credit for the estimated tax payments:

If you and your spouse made separate estimated tax payments for the tax year, you can only take credit for your own payments.

If you made joint estimated tax payments:

Can Agree—If you and your spouse (or ex-spouse) can agree upon an allocation of the payments, then you may allocate them in any manner you wish, provided that the allocated total is the same as the jointly paid amounts for the year.

Cannot Agree—If you and your spouse (or ex-spouse) cannot agree upon an allocation, then you must divide the payments in proportion to each spouse's individual tax as shown on your separate returns for the tax year.

***Example**: You and your spouse (or ex-spouse) made joint estimated tax payments totaling $3,000. You file separate returns and cannot agree on how to divide estimates. Your separate tax liability is $4,000, and your spouse's is $1,000.*

Your share = 4,000/5,000 x 3,000
= $2,400

Spouse's share = 1,000/5000 x 3,000
= $ 600

Divorced Taxpayers—If the taxpayers made joint estimated tax payments for the year and were divorced during the year, either spouse can claim all the payments or they each can claim part of them. If the taxpayers cannot agree on how to divide the payments, they must divide them in proportion to each spouse's individual tax as shown on their separate returns for the year.

How and Where to Make Payments

Payments should be accompanied by an IRS payment voucher. These vouchers, one for each quarterly payment, are included with the IRS Form 1040-ES. Each voucher includes the payment due date and areas for the taxpayers' name, SSN, address, and the amount of the payment.

The voucher and your check payment should be mailed to the address for your specified geographical area. The addresses change frequently and are included on the voucher instructions.

The payments are actually being sent to what is referred to as a lockbox. The lockboxes are generally operated by bank personnel who credit your account by Social Security Number and deposit the funds into the U.S. Treasury.

When making out your check payment, be sure to write the words "Estimated Tax," the tax year, and your SSN in the notation area of your check. This way if your check and the payment voucher become separated, the funds can still be properly credited to your account.

Name Change

If you had a name change and made estimated tax payments using your old name, attach a brief statement to the front of your tax return indicating:

- When you made the payments;
- The amount of each payment;
- The IRS address to which you sent the payments;
- Your name when you made the payments; and
- Your social security number.

The statement should cover payments you made jointly with your spouse as well as any you made separately.

The advice included in this brochure is not intended or written by this practitioner to be used, and it cannot be used by a practitioner or taxpayer, for the purpose of avoiding penalties that may be imposed on the practitioner or taxpayer.

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Making Estimated Tax Payments

Client Information Series

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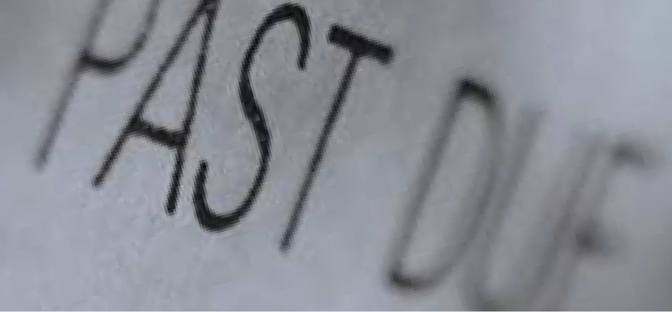

Why Pay Estimates?

The tax system is intended to be a "pay-as-you-go" system, and the only way to prepay taxes is through withholding and estimated taxes. Generally, payroll comes to mind when we think about withholding, but withholding is also available through a variety of other means, including pension income and Social Security payments. However, there are a multitude of income sources that generally do not have withholding, such as self-employment, interest, dividends, rents, gains from stock sales, alimony etc. Estimated tax payments provide a means of prepaying one's taxes on these kinds of income.

However, the use of estimated tax vouchers is not limited to taxpayers with income not subject to withholding. A variety of situations might arise that warrant the use of estimated taxes, such as taxpayers who are paid by commissions or who receive bonuses that distort their income. Frequently, a married couple with substantial income may also rely on estimated taxes to supplement its wage withholding.

Are Estimates Mandatory?

No, it is not mandatory for you to make estimated tax payments. However, if you end up owing money when you file your tax return, then you might be subject to the underpayment of estimated tax penalty. Unless you meet one of the exceptions explained later, this penalty could apply even if all of your income sources are subject to withholding.

What Is the Penalty?

It is a nondeductible interest penalty computed on a quarterly basis. The interest rate varies from year to year based on the prevailing interest rates. Over the past few years, the rates have varied between 5% and 9%.

Estimate Due Dates

Payments are due on the 15th day after the end of the quarter, giving a taxpayer 15 days to compute their tax liability for the quarter. The tax quarters are not all the same duration.

- The first quarter is three months (Jan–Mar),
- the second quarter is two months (Apr–May),
- the third quarter is three months (June–Aug), and
- the final quarter is four months (Sep–Dec).

Note: If a due date falls on a Saturday, Sunday, or holiday, the due date will be the next business day. The reason the due dates are on the 15th is to give taxpayers time to compute their tax liability for the quarter.

The due dates are:

If paid all at once, the due date is April 15.

If paid in installments, the due dates are:

- First payment: April 15 of the tax year
- Second payment: June 15 of the tax year
- Third payment: Sept. 15 of the tax year
- Fourth payment: Jan. 15 of the following year; or if the tax return is filed by Jan. 31 of the following year and the entire balance is paid with the return, the Jan. 15 payment may be skipped.

The payment in January of the following year confuses some taxpayers who attempt to take credit for payment in the following year since that was the year in which it was paid. If you miss a payment due date, you should make the payment as soon as possible!

Farmers and Fishermen Exception—With at least two thirds of their gross income for the prior year or the current year from farming or fishing, they may:

- Pay all of their estimated tax by Jan. 15 (fourth quarter due date); or
- File their tax return on or before March 1 and pay the total tax due.

How to Avoid the Penalty

There are a number of exceptions to the underpayment of estimated tax penalty, which can help you plan your estimated payments, avoid the penalty and minimize the advance payments.

No Tax Liability In Prior Year—A taxpayer is exempt from the underpayment of estimated tax penalty if they had no tax liability in the prior year and they were a U.S. citizen or resident for the whole year. For this rule to apply, the tax year must have included all 12 months of the year.

De Minimis Exception—Taxpayers can owe up to $1,000 on their tax return without penalty.

Current Year Exception—If a taxpayer's withholding and estimated tax payments are equal to 90% or more of the current year's tax liability, then there is no penalty.

Prior Year Exception—The underpayment can also be avoided by prepaying through withholding and estimated tax payments an amount equal to 100% or more of the prior year's tax liability. Caution: See High Income Taxpayers below.

Prior Year Exception for High Income Taxpayers— For taxpayers with gross incomes (AGI) in excess of $150,000 ($75,000 for married taxpayers filing separately), the prepayments must total 110% of the prior year's tax. This penalty exception is frequently used by taxpayers as means of determining a safe harbor estimate for the current tax year.

Annualized Income Exception—A complicated exception can help you avoid the underpayment of estimated tax penalty if you have large changes in income, deductions, additional taxes, or credits that require you to start making or adjusting estimated tax payments.

The payment amounts will vary based on your income, deductions, additional taxes, and credits for the months ending before each payment due date. As a result, this method may allow you to skip or lower the amount due for one or more payments.

Farmers and Fishermen Exception—If at least two-thirds of the taxpayer's gross income for the prior year or the current year is from farming or fishing, the taxpayer's required annual payment is the smaller of:

- 66 ²⁄₃ % (.6667) of the total tax for the year, or
- 100% of the total tax shown on the prior year, provided the prior year was for a full 12 months.

Determining the Amount to Pay

Individuals generally pay estimates in even quarterly amounts utilizing one of the underpayment exceptions or by pre-estimating their taxes for the year. However, payments can be adjusted quarterly, allowing payments to be skipped or stopped if there are fluctuations in income to warrant the adjustment.

How the payments are made is dependent upon a number of factors:

Increasing Income—When a taxpayer's income is increasing and their tax liability will be greater than the year before, the estimates can be based on one of the "Prior Year Exception" methods (either 100% or 110% of the prior year's tax), thereby minimizing the payments and ensuring the underpayment of estimated tax penalty will not apply. Using this approach will require the taxpayer to pay any balance by the April filing due date. This method is especially attractive to taxpayers with substantial increases in income and allows them to delay paying a substantial portion of the increase in tax until the filing due date.