“How Increased Withholding May Avoid Estimated Tax Penalty For Some Taxpayers”

Some individuals with substantial income in addition to salaries may find that the amount of tax withheld from their salaries isn't enough to cover their required estimated tax payments. This may be the result of miscalculation, or forgotten surprises pleasant and unpleasant. A pleasant forgotten surprise might be a windfall on the sale of a capital asset earlier this year. An unpleasant one might be the realization by a taxpayer who claimed a first time homebuyer credit in 2008 that he must begin repaying the credit in 15 installments, beginning with the 2010 tax year. As this article explains, increased withholding, as well as a couple of creative workarounds, can stave off an estimated tax penalty.

Background - An individual subject to the estimated tax must pay, on each of four installment dates (April 15, June 15, September 15 and January 15 of the following year for a calendar-year taxpayer), 25% of his **“required annual payment”** for the current year. The required annual payment generally is the lesser of 100% of the tax shown on the taxpayer's return for the preceding year or 90% of his tax for the current year. However, in figuring 2010 estimated taxes, taxpayers whose 2009 AGI was over $150,000 have to pay the lesser of 110% of the tax shown on the 2009 return or 90% of their 2010 tax liability.

The applicable test is applied separately to each installment. Thus, a taxpayer may be penalized for the underpayment of estimated taxes for any installment for which his estimated tax payments plus taxes withheld from his salary don't total at least 25% of his required annual payment.

An individual who has underpaid an estimated tax installment can't avoid the penalty by increasing his estimated tax payment for a later period (although payment in a later period will reduce the period for which the penalty applies).

Increased withholding is one possible solution - Income tax withheld by an employer from an employee's wages or salary is treated as paid in equal amounts on each of the four installment due dates unless the individual establishes the dates on which the amounts were actually withheld. Thus, if an employee asks his employer to withhold sufficient additional amounts for the rest of the year, the penalty can be retroactively eliminated. This is because the heavy year-end withholding will be treated as paid equally over the four installment due dates.

Other amounts may also be treated as retroactive payments of estimated tax - The same rules described above in regard to amounts withheld from wages and salaries also apply to overpayments of Social Security taxes and to income taxes withheld from:

- supplemental unemployment compensation benefits, sick pay, pensions, annuities and other deferred income (e.g., 20% withholding on certain “eligible rollover distributions” from qualified retirement plans and other deferred income arrangements)
- interest and dividends subject to backup withholding
- gambling winnings.

Another possible option for a taxpayer who has underpaid estimated tax is to take an eligible rollover distribution from a qualified plan before the end of 2010. Income tax will be withheld from the distribution and will be applied toward the taxes owed for 2010. The taxpayer can then timely roll over the gross amount of the distribution, as increased by the amount of withheld tax, to a traditional IRA. No part of the distribution will be includible in income for 2010, but the withheld tax will be applied pro rata over the full tax year to reduce previous underpayments of estimated tax.