A penalty will apply if a taxpayer fails to make sufficient estimated tax payments during the year. The appropriate combination of quarterly estimated tax payments and withholdings on wages (and certain other income) can enable the taxpayer to avoid this penalty. Proper tax planning may help you minimize the required estimated tax payments and avoid the underpayment penalty.
AVOIDING THE PENALTY

You will not owe the penalty for the underpayment of estimated taxes if the amount of taxes you pay (through withholding and/or timely paid estimated tax payments) is the lesser of:

- 90% of the actual tax shown on your 2013 tax return, or
- 110% of the tax on your 2012 tax return based on a safe harbor exception (100% if the adjusted gross income on your 2012 return was $150,000 or less, or $75,000 if married filing separately), or
- 90% of your actual tax for 2013 based on the annualized income installment method (See Tax Tip 4).

The penalty is determined on a quarterly basis combining the withholding tax and timely paid quarterly estimated taxes. You may still owe the penalty for an earlier due date shortage, even if you pay the tax in later quarters to make up the underpayment. It may be possible to avoid this situation by using the annualized income installment method (See Tax Tip 4). Alternatively, you may increase withholding taxes to be applied to the beginning of the year.

WHAT’S NEW FOR 2012?

When estimating your 2012 income tax liability, make sure to consider the following changes for tax year 2012:

- **Lifetime Learning credit income limits increased.** In order to claim the maximum lifetime learning credit, AGI must be less than $53,000 ($106,000 if married filed jointly). The credit is fully phased out at AGI of $63,000 ($126,000 for joint filers).

- **Itemized deduction and exemption phaseouts.** There were no itemized deduction or exemption phaseouts through 2012. However, the phaseouts are revived starting in 2013 for taxpayers with AGI over $300,000 ($250,000 for single filers).

- **AMT exemption amount increased.** The AMT exemption amount for 2012 increased to $50,600 for single taxpayers ($78,750 for married taxpayers filing jointly); and $39,375 if married filing separately. The increases in exemption amounts were made permanent by the 2012 Tax Act and will be indexed for inflation after 2012.

- **Temporary decrease in employee’s share of payroll tax.** For 2012, employee’s wages up to the Social Security limitation of $110,100 were withheld at the rate of 4.2% (down from 6.2%). There is no change in Medicare withholding. The same reduction applies to net earnings from self-employment. The temporary rate was 10.4% (down from 12.4%). For 2013, the payroll holiday has expired and was not extended by the 2012 Tax Act.

Reminders:

- **Roth IRAs:** For 2010 Roth IRA conversions, the second half of the conversion income must be included in 2012 income if the election was not made to include all of the conversion income in 2010.

**tax tip 4**

**USE THE ANNUALIZED INCOME INSTALLMENT METHOD TO REDUCE YOUR QUARTERLY ESTIMATES AND ELIMINATE THE UNDERPAYMENT OF ESTIMATED TAX PENALTY**

The annualized income installment method is a pay-as-you-go method to calculate the required quarterly estimated tax payments.

You may receive income, such as business income, bonuses and capital gains unevenly throughout the year. If you expect to earn more income in the latter part of 2013 than in the first months of the year, or pay deductible expenses earlier in the year, you can reduce your quarterly estimated tax payments by paying the tax based on actual quarterly tax projections. This method provides a way to pay less estimated tax than the safe harbor method based on 110% (or 100% if applicable) of your actual prior year tax for the quarter with lower income. If your income changes in a subsequent quarter, you may increase or decrease the future estimated tax payments accordingly.

You can also use the annualized income method to reduce a potential penalty on your 2013 return. If the safe harbor exception based on 110% of your 2012 tax or 90% of your actual 2013 tax does not eliminate the penalty, you can still use the annualized income method when preparing your 2013 return to reduce or eliminate the penalty.

**SPECIAL RULE:**

The IRS provided taxpayers affected by Super Storm Sandy until February 1, 2013 to pay the 4th quarter 2012 estimated taxes. This should be taken into account when the penalty of underpayment of estimated tax is calculated for 2012.
Tax benefits extended. The following benefits that were scheduled to expire and have been extended by the 2012 Tax Act are as follows:

1. Personal tax credits allowed against regular tax and AMT have been permanently extended beginning in 2012.

2. Work opportunity tax credit available for 2012 for unemployed veterans has been retroactively extended from 2012 through 2013.

3. Deduction for qualified tuition and related expenses has been retroactively extended from 2012 through 2013.

4. Nonbusiness energy credits have been retroactively extended from 2012 through 2013.

5. The qualified electric vehicle passive activity credit has been permanently extended.

YEAR-END PLANNING ACTIONS

If your year-end planning indicates that you have already met the 90% test, you may not need to pay some or all your fourth quarter estimated tax installment.

If you realize before year-end that you may owe the penalty for underpayment of estimated tax, you can still reduce or eliminate your penalty by taking one or more of the following actions:

- Pay more tax through salary or other withholdings. Since any tax paid through withholdings will be presumed to have been paid evenly throughout the year, an individual may increase his or her withholding tax before year-end to minimize the underpayment tax penalty attributable to a prior quarter. There are several ways to achieve this:
  1. Increase your W-2 withholding tax for the remaining pay periods this year.
  2. Withhold more than the required bonus rate of 25% (35% rate if the bonus exceeds $1 million) at year-end.
  3. Withhold tax from pension or IRA distributions if you are qualified to do so.

- Increase your estimated tax payment to eliminate the penalty for the fourth quarter.

- Lower your taxable income (if otherwise desirable) by using the year-end tax planning strategies presented in this guide to reduce the quarterly underpayment.

- Eliminate or mitigate the underpayment by using the annualized income installment method.

Caution: If you withdraw money from an IRA and have taxes withheld, you will need to replenish the IRA within 60 days with the gross amount withdrawn, not just the net amount (i.e., assuming you still want the money in a tax-deferred retirement account).

As part of year-end planning, you should consider the current penalty rates. If the penalty rates are relatively low, which has been the case in recent years, and the cash can be invested at higher rates, it may be more cost efficient to just pay the penalty.

Effective January 1, 2013, an additional 3.8% Federal Contribution Medicare Tax will be imposed on the net unearned income of individuals, estates and trusts. Unearned income includes taxable interest and dividend income, capital gains, rents, royalties and other passive investment income. This 3.8% surtax will be subject to the estimated tax payment rules in 2013 or thereafter.

STATE TAX CONSIDERATIONS

The foregoing discussion of tax planning suggestions may also apply to state and local income tax penalties.
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