estimated tax requirements

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.

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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 current year's tax return, or
- 110% of the tax on your prior year's tax return based on a safe harbor exception (100% if the AGI on your prior year's return was $150,000 or less, or $75,000 if married filing separately), or
- 90% of your actual tax for the current year 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 evenly throughout the year.

WHAT'S NEW FOR 2017 AND 2018?

When estimating your income tax liability, make sure to consider the following changes commencing for tax years beginning in 2017 and 2018:

- **Tax rates remained stable in 2017.** For 2017 the individual income tax rates remained at 10, 15, 25, 28, 33, 35 and 39.6% for ordinary income. The top rate for long-term capital gains and qualified dividends remained at 20%. The applicable threshold amounts for the 2017 top tax rates are: $470,700 for married filing jointly; $444,550 for head of household; $418,400 for single; and $235,350 for married filing separately.
- **New tax rates in 2018.** For 2018 and subsequent years, the individual income tax rates will be at 10, 12, 22, 24, 32, 35 and 37% for ordinary income. The top rate for long-term capital gains and qualified dividends will remain at 20%. The 2018 applicable thresholds are $600,000 for married filing jointly; $500,000 for head of household; $500,000 for single; and $300,000 for married filing separately.
- **Personal exemption phaseouts increased in 2017.** For tax year 2017, the personal exemption amount remained at $4,050 for taxpayers with AGI at or below $313,800 if married filing jointly; $287,650 if head of household; $261,500 if single; or $156,900 if married filing separately. The personal exemption amount for taxpayers with AGI above these amounts may be reduced.
- **Personal exemptions are completely repealed for tax years after December 31, 2017, and before January 1, 2026,** as a result of the Tax Cuts and Jobs Act.
- **Standard deduction increased in 2018.** The Tax Cuts and Jobs Act increased the standard deduction to $24,000 for joint filers; $18,000 for unmarried individuals with at least one qualifying child, and $12,000 for single filers. The amount of the standard deduction will be indexed for inflation using the Chained CPI in tax years beginning after 2018. The increased standard deduction amounts expire after December 31, 2025.

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 2018 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 2018 return. If the safe harbor exception based on 110% of your 2017 tax or 90% of your actual 2018 tax does not eliminate the penalty, you can still use the annualized income method when preparing your 2018 return to reduce or eliminate the penalty.

- **Itemized deductions limited for tax years after December 31, 2017 and before January 1, 2026.** The Tax Cuts and Jobs Act suspends all miscellaneous itemized deductions that are subject to the 2% floor, as well as state and local income taxes and real property taxes (individuals may elect to deduct up to $10,000 ($5,000 for married filing separately)). Amounts paid in a tax year beginning before January 1, 2018 relating to state or local income taxes beginning after December 31, 2017 are treated as if paid on the last day of the tax year for which such tax is imposed. The mortgage interest deduction is reduced with respect to home acquisition indebtedness of $750,000 incurred after December 15, 2017. The limitation reverts back to $1 million after December 31, 2025 regardless of when the debt was incurred. See the chapter on interest expense. The overall limitation on itemized deductions is suspended until January 1, 2026.

- **AMT exemption amount increased.** The AMT exemption amount, which is indexed annually for inflation, has increased to $54,300 in 2017 for single taxpayers, $84,500 for married filing jointly and $42,250 if married filing separately. For 2018, the amounts are $70,300 for singles, $109,400 for married filing jointly, and $54,700 for married filing separately.

- **Increase in employee's share of payroll tax.** For 2017, employee's wages up to the Social Security limitation of $127,200 were withheld at the rate of 6.2%. For 2018, the Social Security limitation is increased to $128,400. There is no change in Medicare withholding.

- **Lifetime learning credit income limits increased.** For 2017, in order to claim the maximum lifetime learning credit, modified AGI must be less than $56,000 ($112,000 if married filing jointly). Modified AGI above these levels gradually phases out the credit, with no credit available for AGI in excess of $66,000 ($132,000 for married joint filers). For 2018, the amount is increased to $57,000 ($114,000 if married filing jointly).

- **Tax benefits extended.** Some special tax incentives known as "extenders" had expired after 2014. However, these provisions have been reinstated retroactively for 2015 and beyond as a result of PATH.

  1. IRA distributions to a qualified charitable organization. Up to a maximum of $100,000 per taxpayer will be tax free if the distribution from an IRA account to a public charity is made by a taxpayer age 70½ or older. This special distribution will satisfy the minimum distribution requirements. This provision has been made permanent and is effective for distributions made in taxable years beginning after December 31, 2014.
  2. Work Opportunity tax credit for unemployed veterans extended through taxable years beginning on or before December 31, 2019.

OTHER TAX CONSIDERATIONS

- **Additional Medicare Tax on Earned Income.** A 0.9% additional Medicare tax applies to Medicare wages and self-employment income. This additional Medicare tax applies to income over the threshold of $250,000 for married filing jointly and $200,000 for any other filing status ($125,000 for married filing separately).

- **Net Investment Income Tax (NIIT).** There is a surtax of 3.8% on the lesser of net investment income or the excess of modified AGI over the threshold amount. The threshold amount is $250,000 for joint filers or a surviving spouse ($125,000 for married filing separately) and $200,000 for any other filing status.

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 of 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 treated 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% (39.6% (for 2017) or 37% (for 2018) 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.

STATE TAX CONSIDERATIONS

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