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 2016 AND 2017?

When estimating your income tax liability, make sure to consider the following changes commencing for tax years beginning in 2016 and 2017:

- **Tax rates remained stable.** For 2016 and subsequent years the individual income tax rates will remain at 10, 15, 25, 28, 33, 35 and 39.6% for ordinary income. The top rate for long-term capital gains and qualified dividends will remain at 20%. The applicable threshold amounts for the 2016 top tax rates are: $466,950 for married filing jointly; $441,000 for head of household; $415,050 for single; and $233,475 for married filing separately. The 2017 applicable thresholds are $470,700 for married filing jointly; $444,550 for head of household; $418,400 for single; and $235,350 for married filing separately.
- **Personal exemption phaseouts increased.** For tax years beginning in 2016, the personal exemption amount is increased to $4,050 (remains at $4,050 in 2017) for taxpayers with AGI at or below $311,300 if married filing jointly ($313,800 in 2017); $285,350 if head of household ($287,650, in 2017); $259,400 ($261,500, in 2017) if single, or $155,650 ($156,900 in 2017) if married filing separately. The personal exemption amount for taxpayers with AGI above these amounts may be reduced.
- **AMT exemption amount increased.** The AMT exemption amount, which is indexed annually for inflation, has increased to $53,900 in 2016 for single taxpayers, $83,800 for married filing jointly and $41,900 if married filing separately. For 2017, the amounts are $54,300 for singles, $84,500 for married filing jointly, and $42,250 for married filing separately.
- **Increase in employee's share of payroll tax.** For 2016, employee's wages up to the Social Security limitation of $118,500 were withheld at the rate of 6.2%. For 2017, the Social Security limitation is increased to $127,200. There is no change in Medicare withholding.
- **Lifetime learning credit income limits increased.** For 2016, in order to claim the maximum lifetime learning credit, modified AGI must be less than $55,000 ($111,000 if married filing jointly). Modified AGI above these levels gradually phases out the credit, with no credit available for AGI in excess of $65,000 ($131,000 for married joint filers). For 2017, the amount is increased to $56,000 ($112,000 if married filing jointly).

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 2017 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 2017 return. If the safe harbor exception based on 110% of your 2016 tax or 90% of your actual 2017 tax does not eliminate the penalty, you can still use the annualized income method when preparing your 2017 return to reduce or eliminate the penalty.

- **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.

  3. Deduction for qualified tuition and related expenses extended through December 31, 2016.

  4. Nonbusiness energy credits extended through December 31, 2016.

  5. Exclusion from income the cancellation of indebtedness of up to $2 million on a qualified principal residence extended through December 31, 2016.

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% 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.