YEAR-END PLANNING: HOW INCREASED WITHHOLDING MAY ELIMINATE ESTIMATED TAX PENALTY FOR SOME TAXPAYERS

Some individuals with substantial income in addition to salaries may find the amount of tax withheld from their salaries isn't enough to cover their required estimated tax payments. This may be the result of, for example, miscalculations or unusual sources of income - for example, a windfall on the sale of a capital asset earlier in the year, or unexpected exposure to the 3.8% surtax (Medicare contribution tax on net investment income). As this *Hot Topic* explains, increased withholding, as well as a creative workaround, 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, and September 15 of the current year, 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 2015 estimated taxes, taxpayers whose 2014 AGI was over $150,000 have to pay the lesser of 110% of the tax shown on the 2014 return or 90% of their 2015 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 (and certain other payments such as pensions and annuities) 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 remainder 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.

> Illustration: Jane expects her 2015 tax liability to be $15,000. Her 2014 return showed a liability of $14,000. Her regular withholding for 2015 will total only $10,500, and she has made no estimated tax payments. If she makes an additional estimated tax payment of $3,000 on January 15, 2016, she will avoid any underpayment penalty for the last installment ($10,500 plus $3,000 equals $13,500, which is 90% of $15,000), but she may still be penalized for underpaying the first three installments. But if Jane instead has her employer withhold an additional $3,000 before the end of 2015, her total withholding ($13,500) will be treated as estimated tax payments of $3,375 on each of the installment due dates. Since $3,375 is 25% of $13,500 (90% of $15,000), the underpayment penalty is

completely avoided for all four installments.

Other amounts may also be treated as retroactive payments of estimated tax. The same rules described above for 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; and
- Certain gambling winnings.

Additional Medicare tax. The additional 0.9% Medicare (hospital insurance, or HI) tax applies to individuals receiving wages with respect to employment in excess of $200,000 ($250,000 for married couples filing jointly and $125,000 for married couples filing separately). The tax is in addition to the regular Medicare rate of 1.45% on wages received by employees. The tax only applies to the employee portion of the Medicare tax.

The 0.9% additional Medicare tax is treated as a tax subject to estimated tax payment requirements. In the case of employees, the additional 0.9% Medicare tax is collected through withholding on FICA wages (or Railroad Retirement Tax Act (RRTA) compensation) in excess of $200,000 in a calendar year. Employers must withhold the additional Medicare tax from wages in excess of $200,000 regardless of filing status or other income. To the extent not withheld, the 0.9% additional Medicare tax must be included when making estimated tax payments.

The Medicare tax on self-employment income is also increased by an additional 0.9% of self-employment income exceeding the same thresholds as apply for employees (see above). But the $250,000, $125,000, and $200,000 thresholds are reduced (but not below zero) by any wages taken into account in determining the additional 0.9% HI tax on wages.

Some taxpayers should consider having more income tax withheld if they have not had enough Medicare tax withheld. This could occur, for example, where an individual earns $200,000 from one employer during the first half of the year and a like amount from another employer during the balance of the year. The taxpayer would owe the additional Medicare tax, but there would be no withholding by either employer for the additional Medicare tax since wages from each employer don't exceed $200,000.

Also, in determining whether they may need to make adjustments to avoid a penalty for underpayment of estimated tax, individuals also should be mindful the additional Medicare tax may be overwithheld. This could occur, for example, where only one of two married spouses works and reaches the threshold for the employer to withhold, but the couple's combined income won't be high enough to actually cause the tax to be owed.

Outside-the-box solution. An individual can take an eligible rollover distribution from a qualified retirement plan before the end of 2015 if he is facing a penalty for underpayment of estimated tax and the increased withholding option described above is unavailable or won't sufficiently address the problem. Income tax will be withheld from the distribution at a 20% rate and will be applied toward the taxes owed for 2015. He can then timely roll over the gross amount of the distribution, i.e., the amount actually received plus the amount of withheld tax, to a traditional IRA within the allowable 60-day period. . No part of the distribution will be includible in income for 2015, but the withheld tax will be applied pro rata over the full 2015 tax year to reduce previous underpayments of estimated tax.