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TAX REPORT

Number of Americans Caught Underpaying Some Taxes Surges 40%

People who pay taxes quarterly—such as gig workers, retirees and business owners—are getting their payments wrong



The Internal Revenue Service is puzzled by the surge in estimated-tax penalties and says it hasn't mounted an enforcement campaign in this area. PHOTO: TIMOTHY FADEK/BLOOMBERG NEWS

By Laura Saunders

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Attention gig workers, retirees, business owners and investors: Double-check your estimated-tax payments to Uncle Sam.

For reasons that aren't clear, a growing number of people who pay taxes quarterly are getting their payments wrong and incurring penalties as a result. These taxpayers often owe estimated taxes because they have income that's not subject to the same withholding as wages earned by employees.

According to Internal Revenue Service data, the number of filers penalized for underpaying estimated taxes rose nearly 40% between 2010 and 2015—to 10 million from 7.2 million.

In 2015, the total number of filers owing penalties may have exceeded the number filing estimated taxes, although final results aren't out yet. This is possible because some who paid quarterly taxes may have made mistakes, and others who didn't pay them should have.

"The data suggest that millions of people don't understand they need to pay quarterly taxes, or at least increase their withholding to avoid penalties," says Eric Smith, an IRS spokesman.

Adding to the mystery is that total estimated-tax penalties over the same period held steady. For 2015, the average penalty was about \$130, compared with about \$210 for 2010.

Estimated tax payments are Congress's way of keeping non-wage earners from having an advantage over wage earners. More than 80% of taxpayers have wages that are typically subject to withholding, and most people pay most of their income tax this way. Thus the law requires people with other types of income to make quarterly payments based on amounts received during each period.

Taxpayers with a mixture of wage and non-wage income must either pay tax quarterly or raise their withholding to cover the non-wage income. If total payments don't meet certain thresholds, then the taxpayer owes a penalty on the underpayment based on interest rates charged by the IRS. Currently the rate is 4%.

The surge in estimated-tax penalties is puzzling experts, even at the IRS. The agency says it hasn't mounted an enforcement campaign in this area.

Tax preparers suspect several factors are at work. For most of the period penalties grew, the interest rate was 3%—the lowest in decades, making the pain of paying them lower as well.

"Some people don't mind paying the toll, especially if their income bunches in the last quarter, and they just owe it for a few months," says Don Williamson, noting the decision also could explain why average penalties have declined. Mr. Williamson is a certified public accountant who heads the Kogod Tax Policy Center at American University and has a private practice.

In addition, more baby boomers are now retiring from full-time work or else taking required distributions from retirement plans after age 70.5. In either case, says Mr. Williamson, they may be unaware they'll owe quarterly payments on some or all income.

These people also may be unaware that Congress has cut them a break. According to an exception in Section 6654, taxpayers who retire or become disabled at 62 or older can often have estimated-tax penalties abated for a year before or after the change. Request this abatement on Form 2210.

Then there is the growth in the gig economy, as millions of Americans look to earn income through platforms such as Airbnb. These earners are often unfamiliar with the idea of paying

quarterly taxes and thus incur penalties at first, says Miguel Centeno of Shared Economy CPA, a firm that specializes in serving taxpayers who receive 1099 forms instead of W-2s.

A 2016 survey conducted by Caroline Bruckner, a managing director at the Kogod Center, found that 69% of self-employed workers in the gig economy received no tax information from the platform they used.

Workers who don't know about estimated-tax payments also may be missing out on useful write-offs.

"Deducting costs, such as complimentary bottles of wine or a portion of the utilities or Netflix bill for Airbnb hosts, can really lower the tax bill," says Mr. Centeno.

For the IRS, growth in estimated-tax penalties in this sector could be ominous. While such penalties tend to be small, every one of them signifies a larger amount of unpaid taxes. Between 2010 and 2015, taxes due at time of filing grew about 60%, to \$161 billion from \$101 billion.

Amounts due often surprise and strain taxpayers, and platforms paying the income may not be required to report it to the IRS. While honest souls will pay what they owe, others will be tempted to walk away. As the IRS knows, income that's not subject to withholding or reporting often leads to taxes never paid.

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