

**Since this newsletter was so well received last year, we are running it again with updates for current info.**

## **Interest and Penalties**

When the filing deadline of April 15<sup>th</sup> has come and gone, and your taxes haven't been filed yet, what happens? If you're smart or lucky, you've filed for an extension. What happens depends on which government agency we're dealing with. I hope to unlock the mysteries and confusion of penalty and interest charges by the US government and the State of Oregon.

Due to a lack of space, I will restrict this discussion to interest and penalties on individual income taxes, although the rates and rules are similar for corporations and for payroll, estate and other taxes.

### **Federal tax penalties and interest**

There are two major types of penalties that IRS charges: failure to file and failure to pay. The names pretty much tell the story.

**Failure to file:** If you don't file a return or extension by the filing deadline (April 15<sup>th</sup> for most of us), you are subject to a penalty for failure to file a timely tax return. This can be an expensive penalty. Beginning the day after your return is due, the penalty starts at 5% of the tax you owe. If you don't pay within one month after your return is due, the penalty increases to 10% of what you owe. The third month you're late, it goes up to 15% of the amount you owe. This continues until the fifth month, when the penalty becomes 25% of the tax you owe and stays there.

**NOTE: WHEN YOU'RE FILING A TIMELY RETURN, IRS ACCEPTS THE DATE MAILED. WHEN YOU'RE LATE, IRS WILL STOP THE CLOCK WHEN THEY RECEIVE THE RETURN AND PAYMENT.** In other words, if you fail to extend your return and mail it with your payment to IRS on May 14<sup>th</sup>, they won't receive it until sometime after May 15<sup>th</sup> (one month late). You will be charged a 10% failure to file penalty.

**Failure to pay:** This penalty is minor compared to the one above. When you file an extension or tax return without payment, IRS will charge ½ of 1% (.5%) monthly penalty on your unpaid balance. Like the penalty above, this caps out at 25%, so if you're 50 months late in paying, you'd max out this penalty. In case you need a little help with the math, this works out to a 6% annual penalty.

**Interest:** In addition to the penalties listed above, IRS will charge interest on taxes due. IRS issues the rates quarterly; the current rate for underpayment interest is an annual rate of 4%. So if you file an extension or file a return without payment, you'll be charged a 10% (6% penalty plus 4% interest) annual charge on your unpaid taxes. Do you notice that I keep saying things like "unpaid balance" and "penalty based on the amount you owe?" That's right: if you don't owe any taxes, there are no penalties or interest for late filing!

### **The really nasty penalties**

There are very bad penalties out there for very bad people. Penalties can be imposed for negligence, substantial understatement of tax liability and fraud. These penalties can reach 100% of the correct tax owed (correct according to you know who) on top of interest. There is also a \$500 penalty for filing a frivolous return. A frivolous return is one relying on a frivolous position such as saying that taxes are unconstitutional. Trust me on this one; you want to avoid this category of penalties.

### **Oregon state penalties and interest**

Believe it or not, the folks in Salem are a lot tougher than IRS on basic penalties and interest for the vast majority of taxpayers. With just a few exceptions, the rules for applying Oregon penalties and interest are the same. I'll lay out the differences.

First of all, the interest rate is higher. It is now, and it has been as long as I've been paying attention to it. Oregon currently charges 5% annual interest on unpaid balances. Oregon updates this rate annually as opposed to IRS doing it quarterly.

The second big difference is in the failure to pay area. If you extend your filing deadline and don't pay, Oregon will charge you a 5% penalty. If you file more than three months after the due date or extension due date, Oregon will tack on another 20%, bringing the penalty to 25% of your unpaid tax. To avoid the 5% penalty, you must do all of the following: 1. File an extension. 2. Pay at least 90% of the tax that you should have paid by April 15<sup>th</sup>. 3. Pay the balance of the tax due when you file by the extension deadline, and 4. Pay the interest within 30 days of Oregon billing you.

This is saying that, even if you don't know how much tax you're supposed to pay by April 15<sup>th</sup>, Oregon expects you to pay in 90% of whatever that number ends up being. They want you to pay in full before October 15<sup>th</sup>, and they want their interest bill paid within 30 days of their mailing it. Otherwise, they will charge an additional 5% penalty. OUCH!

Last but definitely not least, if you don't file an Oregon return for three consecutive years by the due date of the third return (or the extended due date if you filed an extension), **THERE WILL BE A PENALTY OF 100% OF THE TAX YOU OWE FOR THOSE THREE YEARS!** You thought no one could be worse than IRS? Think again.

### **Underpayment of estimated taxes**

Both IRS and Oregon expect you to pay in throughout the year either via withholding from your paycheck or retirement, or through quarterly estimated tax payments. If you end up owing less than \$1,000 after credits and withholding, you don't need to worry about this. There are two ways to avoid this penalty. 1. Pay in, through withholding or estimates, 100% of your total tax liability from last year (this is the figure on your return above withholding and estimates; it says "total tax"). If your adjusted gross income is over \$150,000 (\$75,000 for married filing separately), you must pay in 110% of last year's tax. 2. Pay in, through withholding or estimates, 90% of this year's tax. The trouble is, you won't know what this year's tax will be until the year is over. We frequently prepare projections for our clients during the year so they'll have a better idea of what to pay in estimates. If you pay estimates, you'll need to pay them in equal quarterly payments; you can't underpay early in the year then make it up later. Strangely enough, you can do this through payroll withholding.

### **Multnomah County**

If you operate a business in Multnomah County and/or Portland and your gross receipts are over \$50,000, you may be subject to the local business tax. Portland has a minimum tax of \$100, and Multnomah County now has \$100 minimum as well. The rules for these taxes are about the same as Oregon's. There is also a TriMet tax for self-employed people in the TriMet district, which follows the same rules concerning extensions and late payments as Oregon does. There is no minimum TriMet payment.

### **New penalties on business taxes**

In the old days (before 2008), if you were late filing an S corporation return or a C corporation which owed no tax, no problem. If it was late or not extended, there was no penalty because it was calculated based on the amount of tax due. In other words, zero. Those days are gone. Now, any late corporate return incurs a penalty of \$86 per month per shareholder with a maximum of 12 months. So, if you're a year late filing a return for your four-shareholder corporation, your penalty would be a whopping \$4,128. The penalty for late partnership returns has increased to \$86 per partner per month.

In addition, Oregon excise tax for all C-corporations, S-corporations, and Partnerships has increased to \$150.

### **New preparer penalties**

You may have noticed that accountants are asking a few more questions this year. We certainly are. This may have something to do with the new preparer penalties that can be imposed on accountants. These penalties are the greater of \$1,000 or half of the fee we charge for a return. They are imposed if the position we take on a return stands a less than 50% chance of being upheld under examination. If it sounds subjective, it is. We're not sure how to calculate that more likely than not standard so we're being a bit more careful.

### **Conclusion**

To avoid the big hit, file an extension and pay in a healthy estimate of what you think you owe. If you can't pay it all, at least pay some to Oregon. If you pay in too much with your extension, you'll get the excess back when you file your return. All you lose is the interest your money would have earned had you not put it towards taxes. Remember that your first quarter estimates are also due April 15<sup>th</sup>.

Happy tax day!

Victor

The information in this newsletter is for informational purposes. If you have questions or concerns about the information in this newsletter, give us a call. Or call another tax advisor if you must.