PERSPECTIVE

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Guidance for navigating legal settlements, legal fees and estimated taxes

By Robert W. Wood

If you get a paycheck that has taxes taken out of it, you probably never thought about estimated taxes. To most people, "estimated tax payments" are a foreign concept. After all, payroll checks have taxes withheld. You can adjust your tax withholding up or down during the year by giving your employer an IRS Form W-4 that claims greater or smaller withholding allowances. Then, when you file your tax return in April (or in October if you go on automatic extension), you either pay more or get a refund.

But what if you don't work for a paycheck but are self-employed? In that event, you don't have tax withholding taken out of your pay. That's where estimated taxes come in. If you are self-employed you probably already know that you can't just pay taxes once a year on April 15. You are supposed to pay the IRS regularly. But here's another example where estimated tax rules apply.

Suppose that you work as an employee, so you have taxes taken out by withholding, but you also have other income? The other income might be a lawsuit settlement, a sale you make of stock or other property, or something else. But however it is generated, having a big slug of income come in during the year without tax withholding should also make you think about estimated taxes. Many plaintiffs who receive all of their income by payroll check are dealing with estimated taxes for the first time when they receive lawsuit settlements.

Taxpayers are generally required to make estimated tax payments over the course of the year. The IRS doesn't want you to wait until the whole tax year passes, only to start thinking about how to pay the IRS when you prepare your tax return the following April. The idea is that you pay in regularly so the IRS gets the money, and so you are not blindsided. Of course, most people would rather hang onto the money and invest it before they pay it to the IRS.

Many a plaintiff settling a case near year end say: Let's see, if I get the money in December, my tax return and payment are due April 15th, less than 4 months later. But suppose that the settlement agreement is signed in December, and says that the defendant must make payment between January 2 and January 15.

Is that constructive receipt? No, because you conditioned your signature on the settlement agreement on when the money would be paid. It would be different if you had signed the settlement first and then asked for delayed payment. By delaying the payment in the settlement agreement itself, your tax payment and return are not due until April 15 of the following year, 15 months later.

That kind of tax planning is pretty attractive to litigants. In fact, you can apply that logic to plenty of year-end tax decisions. But a key discussion missing from this discussion is estimated taxes. Are you OK investing all of the money for that 15 months, or do you need to make estimated tax payments long before you file your return in April or October?

The bigger question is whether you will be penalized if you fail to make estimated tax payments. Many taxpayers do not need to worry because their wage withholdings from their paychecks satisfy their estimated tax obligations. Yet the default rule is that estimated taxes should be paid in equal installments at least quarterly. Penalties can be imposed if any one of the quarterly payments is too low.

However, two rules can help avoid penalties. The first rule regards how much estimated tax must be paid in order to avoid penalties. In order to avoid estimated tax penalties for 2021, the estimated tax you pay must be equal to the lesser of 90% of the tax you owe for the *current* year (2021), or 100% of the tax you owed for the *prior* year (2020). If your adjusted gross income for 2020 was greater than $150,000, then the estimated tax for 2021 needs to be 110% of your 2020 tax rather than 100% of your 2020 tax.

Amounts withheld from wages *count* toward your estimated tax payments. Thus, it is possible that you are already making sufficient estimated tax payments through your wage withholding. That is, if your wage withholding totals100% of your 2020 tax (or 110% of your 2020 tax if your adjusted gross income was over $150,000), then that might be sufficient estimated tax payments for 2021.

If you cannot avoid estimated tax penalties under this percentage rule, it may still be possible to avoid estimated tax penalties on the timing of your estimated tax payments. The default payment schedule for estimated taxes is four equal quarterly payments. Nevertheless, for individuals whose income fluctuates during the year, taxpayers can pay their estimated tax based on the quarter in which they actually received their income.

Thus, your required estimated tax payment for the quarter or quarters before you received your award may be lower than your required estimated tax penalty for the later quarters of the year. The calculation for this is rather complicated. If you need to go down this road, you probably want to have an accountant help you to calculate how much you may need to pay each quarter. The IRS form used to calculate whether a penalty is due for underpaying estimated tax is an IRS Form 2210. The Form 2210 has a Schedule AI, which taxpayers or their accountants can use to identify which quarter they received their income, and how much estimated tax is due for that quarter.

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