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Are You Retired or Semi-Retired? Check Your Tax Withholding Now

Tax overhaul risks leaving pension recipients underwithheld when it comes time to file for 2018

By
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Millions of Americans receiving pensions could be in for a bad tax surprise next year.

A little-noticed effect of last year's tax overhaul is that many pension payments are now larger, reflecting the new lower tax rates in effect for 2018. But this bump-up increases the risk that recipients will be underwithheld at tax time next year—and therefore owe a penalty. To avoid this, retirees should immediately check their withholding and adjust it if necessary.

One who will be checking is Ann Gardella, a retired music teacher now living in Southbury, Conn. She says most of her income is from her pension and the monthly payments rose earlier this year. Because she already has a tax balance due each April, she plans to review her withholding.

"I really don't want to owe penalties next year," says Ms. Gardella.

The situation with pensions is similar to what's happening with paychecks, says Jonathan Zimmerman, a benefits attorney with Morgan, Lewis & Bockius. Earlier this year, Treasury officials adjusted withholding tables to reflect changes for 2018 made by last year's tax overhaul, and these changes have been incorporated into many pension payments as well as employee paychecks.

But these adjustments didn’t take into account many of the overhaul’s changes. For example, the current withholding tables include tax-rate changes but not the effect of the new $10,000 cap on deductions for state and local taxes. The withholding tables have never included this information, according to an IRS spokesman.

The upshot is that some pension recipients could wind up underwithheld in for 2018 because the automatic adjustments to their pension payments set them too high. In general, people must pay in at least 90% of the tax they’ll owe during the year, or by the following mid-January if they are paying quarterly estimated taxes, to avoid a penalty. The penalty is based on an annual interest rate that’s currently 5%.

Pension payments and filers’ circumstances vary widely, so it’s hard to predict who’s at risk here. Mr. Zimmerman says that for a typical married pension recipient with a $50,000 annual pension, the reduction in withholding comes to about $818 a year. That may not sound like a lot, but it cuts withholding by about 20%. A pension payer that follows the government’s tables isn’t responsible if the recipient is underwithheld.

This new wrinkle in pension payments is yet another reason why retirees—especially those who recently retired or are working part time—should be alert for “tax shocks,” says Gil Charney, a director of H&R Block’s Tax Institute.

For many retirees, income doesn’t just drop, he explains. Often it becomes lumpy, especially if someone has part-time work, Social Security payments, or retirement-plan withdrawals. Medical expenses may become deductible for the first time, and additional “standard deductions” kick in at age 65.

Retirees must also decide what to withhold from Social Security payments and payouts from plans such as 401(k)s or individual retirement accounts at the same time that many are switching to quarterly estimated tax payments.

“The onus is on the taxpayer to make sure the withholding is correct,” says Mr. Charney, rather than on both the taxpayer and the employer.

There’s evidence of rising taxpayer problems in this area. Between 2010 and 2016, the number of filers penalized for underpaying estimated taxes rose 36%, from 7.2 million to 9.8 million.

To help with these issues, the IRS has posted a new withholding calculator. It can be used by most filers, including retirees with multiple sources of income, according to an IRS spokesman.

To use it, you'll need a copy of last year's tax return and estimates of this year's sources of income and withholding so far. Based on the results, you may want to submit a revised Form W-4P, for pension and annuity withholding, to the payer.

The form for Social Security withholding is W-4V. Filers can elect to withhold at one of four flat rates—7%, 10%, 12%, or 22%. To change the withholding on the payouts from a retirement plan such as an IRA or 401(k), check with your provider.

What if a filer underpays estimated taxes? The law offers two outs. There's often no penalty if income is less than $150,000 and the filer has paid in an amount equal to 100% of his tax for the prior year. For those earning more than $150,000, the threshold rises to 110% of the prior year's tax.

The other is that the IRS often waives estimated tax penalties incurred in the year someone retires or becomes disabled, or sometimes the year after that. To qualify, the taxpayer submits Form 2210 with proof and an explanation that the error wasn't willful.

But this relief often comes after a scary letter from the IRS and filling out yet another form—so avoid it if you can.

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