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A Creative Way to Pay a Tax Liability

By ALEX COPPOLA

With Jan. 1 fast approaching, Dean Hedeker's client was in a tight spot.

During his year-end planning meeting, Mr. Hedeker discovered that the 70-year-old retired man had failed to make any of his estimated tax payments for the year.

Based on his previous year's income, the man was supposed to make quarterly payments of $25,000. Now, he still owed the full $100,000, plus a potential penalty of nearly $3,000 for his delinquent payments. The client also worried about other potential consequences of his mistake.

"He was panicked that his error would be a red flag that would land him on the IRS's radar," says Mr. Hedeker. His firm, Hedeker Wealth Management Group, manages $200 million for 200 clients in Lincolnshire, Ill.

Fortunately, the adviser knew that his client--who had more than $1 million in taxable savings--still had an opportunity to make things right. For starters, he told the man he could satisfy his $100,000 liability by making a lump-sum payment to the IRS in December. But that approach would leave him facing a fine for the previous missed payments.

Instead, Mr. Hedeker suggested another approach: Instead of cutting the IRS a check from his taxable accounts, the client could withdraw $100,000 from his IRA and withhold that entire amount for the taxes. The difference, Mr. Hedeker explained, is that unlike direct payments to the IRS, withholding is ratable. Rather than being considered a single payment, the $100,000 withholding would be treated as if it had been paid periodically during the year.

"This way, it would be exactly like he had made his scheduled $25,000 installments each quarter," Mr. Hedeker explains.

The client had $500,000 in his IRA--more than enough to cover the payment. What's more, he could easily replenish the account from his taxable savings. The client liked the plan, so he and Mr. Hedeker filed a withdrawal form that instructed the account's custodian to withhold 100% of the amount for the federal government.

"The client got a check for $0, the IRS got one for $100,000, and like that his annual liability was fulfilled," says Mr. Hedeker.

Next, Mr. Hedeker enacted the second step of his strategy. Even though the client's withdrawal had gone directly to the IRS, it was still considered a distribution from his IRA and would have raised his income tax bill by close to $36,000.

To avoid that tax, the client needed to put $100,000 back into his IRA within 60 days. That way, the distribution would be treated as a rollover and be exempt from taxes. So within the week, he replenished the account from his taxable savings.

With his estimated payments settled and his IRA refunded, the client was relieved to have avoided tax penalties and the potential scrutiny of the IRS. But Mr. Hedeker notes that the strategy is not simply an 11th-hour fix for clients who have missed their estimated payments. It could be part of an annual wealth-management strategy for the right clients.

"Why give up tax-deferred interest by making quarterly payments when you could keep those assets invested the whole year?" he says. "If a client has the requisite savings available, this is a creative tool for year-end planning."

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