Adjusting your income tax withholding

If you typically receive a large refund from IRS after you file your income tax return, or you owe the IRS a substantial amount at that time, you should consider adjusting your income tax withholding.

Your employer withholds income tax from your paycheck based on the number of withholding allowances you claim on Form W-4, Employee's Withholding Allowance Certificate. You must give your employer a Form W-4 when you first begin work.

If your tax circumstances change, it's up to you to give your employer a new W-4. Many employees neglect to take this step, resulting in withholding that is either too high or too low.

If your withholding is too high, you are in effect giving the government an interest-free loan. Although the overpaid tax will be refunded once you file your return, you would have been better off using the money during the year to generate income or for personal purposes. In this case, you should reduce the amount your employer withholds to increase your regular take-home pay.

At the other extreme are taxpayers who have too little withheld and who owe substantial amounts come April 15th. While they enjoy the "extra" amounts received in each paycheck, they must pay back the taxes owed in April, and will likely be tacking on extra in the form of penalties. If this is your situation, you should increase your withholding. As a rough guideline, you should owe less than 10% of your tax bill come April.

Even if you have had too little tax withheld for most of the year, you still may be able to avoid a penalty by asking your employer to withhold additional amounts for the rest of the year. This is because the increased withholding at year's end will be treated as paid equally throughout the year.

You should check your withholding whenever significant personal or financial changes occur in your life, including the following:

- **Changes in filing status or exemptions:** You get married or divorced; you have a new child; a child goes off on his or her own.
- **Changes in wage income:** You or your spouse start or stop working, or start or stop a second job.
- **Changes in income not subject to withholding:** You have an increase or decrease in rental income, interest income, dividends, capital gains, or IRA distributions.
- **Changes in deductions and credits:** You take out or pay off a mortgage; you become entitled to the dependent care credit, child tax credit, or the higher education credit; you have changes in medical, alimony, or job expenses.
- **Changes in other taxes:** You owe self-employment tax or employment taxes for your household workers.

Unfortunately, the procedures for arriving at the proper withholding amounts are among the more complex ones taxpayers confront. A wide array of factors play a role: exemptions, deductions, credits, marital status, your spouse's income, and others. The Form W-4 includes three worksheets that you may have to complete to determine the proper withholding.