

What are estimated taxes and how should I pay them throughout the year?

Note: This information is geared toward a shareholder in a closely held corporation or member in a limited liability company that is in a position to reflect a large percentage of the net income or loss of the entity on their personal tax returns as a pass-through item.

Taxpayer Requirements

The IRS requires that an individual pay 25% of a “required annual payment” by April 15th, June 15th, September 15th and January 15th in order to avoid an underpayment penalty. The “required annual payment” for most taxpayers is defined as the lower of 90% of the tax shown on the current year’s return or 100% of the tax shown on the prior year’s return. However, taxpayers whose adjusted gross income (AGI) is greater than \$150,000, have an increased requirement of the lower of 90% of current year tax or 110% of prior year tax.

Example:

Bob and Sally Smith have adjusted gross income in 2009 of \$183,000. Their tax liability in 2009 was \$46,000. Their tax liability in 2010 is \$54,000. Bob and Sally’s AGI is greater than \$150,000 in 2009. Therefore, they must pay in the lower of 110% of 2009 tax (\$50,600) or 90% of 2010 tax (\$48,600). The lower amount is \$48,600 therefore Bob and Sally must make estimated tax payments of at least \$48,600 in 2010.

The tricky part of the example is knowing what Bob and Sally’s AGI is going to be in 2010. Many tax advisors will prepare a “safe harbor” estimate for their clients by calculating what is owed based on prior year tax. By making a safe harbor estimate, the client is protected from estimated tax penalties because the amount that is paid in is based on either 100 or 110% of prior year income depending on how much income the taxpayer had and will always be sufficient to cover the minimum estimated tax requirement.

The disadvantage to this method is that if the client’s AGI in 2010 will be substantially different from 2009, then a couple of problems could occur. First, if the client makes substantially less in 2010, then the estimated tax payments will be

too high. And, although the client will get a large refund when their tax return is prepared, they may have preferred to have those funds available to them sooner.

The second risk is that if income increases substantially, then the client could have a large liability due with their tax return. They would avoid the estimated tax penalties, but it may be unpleasant to pay a large amount with the tax return.

Methods of Payment

These methods of payment can be evaluated by each individual taxpayer to decide what is beneficial for their particular situation to ensure that they pay the required annual payment and avoid underpayment penalties. Do you prefer to make weekly, quarterly or annual payments? Do you prefer to keep your money until the very end and pay with your return or do you prefer to get a large refund each year? The combination of payment methods can be used to ensure that your goals are met while also avoiding estimated tax penalties for not paying enough throughout the year.

There are two main ways in which to pay your federal income tax during the tax year. One is through federal withholding from a paycheck and the other is through estimated tax payments. Using one or both of these methods, does not change what you are required to pay. It is just a means to simplify how you pay taxes based on your personal preferences and to avoid penalties for underpaying.

Federal Withholding from Paychecks

Federal withholding is often the easiest way to pay estimated taxes. This is especially true for S Corporation shareholders that are required to take salary when they are working within the corporation. Any withholding from a paycheck is treated as a payment of estimated tax. An equal part of the withheld tax is considered paid on each installment date unless the individual establishes the dates the amounts were actually withheld. This means that a taxpayer who might otherwise be subject to an underpayment penalty for earlier periods in the year can avoid or reduce the penalty by increasing withholding in later months.

Example:

Steve Jones is the sole shareholder of his S corporation. He would prefer to not make large payments of tax and instead make smaller payments on a semi-monthly basis. Steve is required to make \$24,000 in estimated tax payments in 2010. Steve can pay himself a salary twice a month and take \$1,000 in federal

withholding from each check. This will meet the requirement of \$24,000 in estimated tax payments and Steve can avoid making larger payments each quarter.

Example 2:

Now assume that Steve does not want to deal with payroll until the end of the year. Also assume that Steve does not want to pay taxes that differ materially from what he is actually going to owe on his tax return. Steve can work with his tax preparer at the end of the year to determine, as closely as possible, what Steve's actual tax liability for 2010 should be. They determine that Steve will most likely owe only \$21,000 in tax for 2010. Steve can cut himself a paycheck dated December 31st for an amount sufficient to withhold the entire amount of federal withholding that he needs to pay. Steve can either withhold the \$21,000 based on what he should owe or he can withhold the safe harbor amount of \$24,000. The paycheck must be dated within the tax year (i.e. December 31st) and then the federal withholding is paid with the next payroll tax deposit. And, the tax is deemed to have been paid quarterly as required by the IRS even though it was paid at the end of the year.

Note: The IRS does require that a Form W-4 is completed to reflect what is taken from the paycheck. Also, when completing a W-4 it is mandatory that a filing status and number of exemptions are selected. So, when completing the W-4, you can enter a filing status and number of exemptions and then enter the additional tax to be deducted in the "Additional Amount" line on Form W-4.

Estimated Income Tax Payments

As an alternative to paying estimated taxes through payroll, taxpayers can also pay traditional quarterly installments. This is best for taxpayers who are either paying safe harbor quarterly estimates or taxpayers that are working with their tax preparers on a quarterly basis to determine the estimated payment that is required. It is also ideal for members of limited liability companies as they do not have a payroll requirement and therefore would only be creating a paycheck to themselves to cover estimated tax payments.

When paying quarterly estimated tax payments, the taxpayer must pay 25% of the required annual payment each quarter. The due dates for these payments are April 15th, June 15th, September 15th and January 15th. The payments must be made using payment voucher Form 1040-ES either by phone or online via the IRS's EFTPS system.

There is an exception to the requirement to pay equal quarterly installments called the "adjusted seasonal installment" method. This does not change the annual

required payment but instead weights the payment in quarter where revenues are highest. This is most commonly used by ski resorts, golf courses, landscape contractors or other entities where there is a strong seasonal trend in their revenues.

Example:

For Steve Jones above, let's now assume that he has an LLC rather than an S Corporation. Steve is not required to take a paycheck from an LLC as he is with an S Corporation. Therefore, he would prefer to pay quarterly estimated tax payments.

If Steve would prefer to make safe harbor contributions, he can pay the \$24,000 annual required payment in four equal installments of \$6,000 on April 15th, June 15th, September 15th and January 15th using Form 1040-ED. If he would prefer to pay actual amounts due, Steve can work with his tax preparer each quarter to determine projected AGI for the year, and make quarterly estimates based on that calculation.

Completing Your Federal Tax Return

After the end of the tax year, when completing your return, the amounts paid under the methods described above will be entered into the return as payments against your actual tax liability. If you have utilized one of the methods described above to make these payments on time, then you should either avoid or substantially reduce any estimated tax penalties.

Personal federal income tax returns are due on April 15th. You can elect to extend your tax return for six months making it due on October 15th. Please note that if there is a balance due on your tax return, that balance is due April 15th regardless of when you file your return. Therefore, if you think you will owe a balance, you should work with your tax preparer to file and pay the balance by April 15th. Any balances still owing will begin accruing interest to the IRS on April 16th. If the return is filed by the extended due date, you will only pay interest and not penalties. If the return is late, you will pay both interest and penalties.

Additionally, the first quarterly estimated tax payment is due on April 15th. Therefore, if you will be extending your tax return, you should attempt to still make an estimated tax payment on April 15th to avoid underpayment penalties going into the next tax year.



For more information on how to manage tax liabilities to best meet your needs or any other tax issues that you face, please contact us at tanya@thecfogroup.com or 775-359-7600.

Also, please see the information on our website www.thecfogroup.com, related to closely held entities for additional guidance on the S corporation and LLC rules referred to above.