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Understanding Estimated Tax Payments

Business owners are only allowed a brief sense of relief once they've completed another year of income tax reporting. After paying last year's tax, you need to turn your focus immediately to your expected tax liability for the current year.

In fact, you might already be late in getting started in this year's tax payments. The Internal Revenue Service (IRS) expects taxpayers to make payments throughout the year. While employees accomplish this via withholding on their wages, business owners typically resort to estimated tax payments.

Underpayment Penalty

Proprietors and partners owe taxes in the quarter income is earned. This is distinct from the salaries that owners of corporations pay to themselves. A salary is the owner's income as an employee, from which taxes are withheld. Corporation profit is viewed as a shareholder's taxable income.

Penalties are assessed if taxes aren't paid by deadlines throughout the year. These payment dates don't fall on equal calendar quarters; due dates are the 15th of April, June, September, and the January after year-end.

Even if you file your tax return and pay all your taxes when filing, you may incur penalties. Submitting your return on time with money due only avoids a late penalty. Failure to remit estimated tax payments throughout the year triggers a different underpayment penalty.

Self-employed Americans are required to submit federal payments for their regular income tax plus their contributions to Social Security and Medicare. Estimated tax payments are normally four equal amounts. California requires payments scheduled as 30%, 40%, 0%, and 30% per quarter, respectively.

This requires making assumptions about annual income and dividing by four. Calculating the correct payment is challenging if your income fluctuates from year to year, or if you have a short business history.

Complex calculations are required if you choose to determine the separate tax liability for each quarter. Only Social Security and Medicare are flat-rates. Income tax, however, is assessed on a graduated scale. There is no such thing as a single rate on business profits alone; your overall tax impact is calculated by combining business profit with other types of income, then estimating your total personal income from all sources minus deductions and tax credits.

If you consult with us on estimated taxes, you'll discover that you can use safe harbor calculation methods to avoid penalty. No underpayment penalty is assessed if your payments for the year are at least 90% of current-year tax. You'll also avoid penalties if you owe less than $1,000.

Typically, you won't incur a penalty if your estimated tax payments this year equal 110% of the taxes you owed for last year. However, you'll still benefit by planning for your actual expected tax liability in the current year.

Identifying a safe harbor quarterly tax payment establishes a floor amount to set in your monthly budget. When you are near year-end, assess whether your income is higher or lower than the preceding year. If it's less, reduce your final quarterly tax payment. If it's more, plan to pay the extra penalty-free balance on your tax return.

Feel free to contact us if you have any questions you may have about your estimates.