Avoid IRS Trouble, Know the Fundamentals of Estimated Tax

By Lawrence 'D' Pew, Arizona Tax Attorney

You work full time. Your employer withholds tax from your paycheck. You don't have to worry about estimated tax, right?

WRONG!

Do you receive spousal maintenance, or alimony?
Are you self-employed by working a side job or two for cash?
Do you owe federal employment tax for your child's nanny?
Are you a sole proprietor, partner, or S-corporation shareholder?
Did you sell property for a lot more than what you paid?
Did you sell any stocks at a large profit?

If you answered "Yes" to any of those questions, then you may want to review the fundamentals of estimated tax. The crux of the matter is whether you have substantial taxable income that is not subject to withholding by your employer. If you do, then you need to increase the amount your employer withholds, make estimated tax payments directly to the Department of the Treasury, or both.

The IRS allows you to make estimated tax payments to pay both income tax and self-employment tax. The estimated tax method is used to calculate and pay income tax when you don't have sufficient withholding to cover the total tax that you will owe by the end of the tax year.

While you are employed, your employer will withhold tax from your paycheck on your behalf. But if you are self-employed or have additional income from other sources and nothing is withheld from that income, then you must pay taxes on that, too. Depending upon your income, you may be required to make estimated tax payments over the course of the year. The IRS expects you to keep up with your tax liability. When the year's taxes become due, you will not face excessive interest and penalties in addition to your tax. This article describes the fundamentals of individual estimated tax so you know how much to pay and when to pay it.

Note: There are special estimated tax rules and specific forms to file when the taxpayer is a corporation, farmer, or fishermen.

What Are the Consequences of Not Paying Estimated Tax?

When you fail to pay enough through your withholding and estimated tax payments to cover your tax liability for each quarter, then you are likely to be charged an *underpayment penalty*. Why? Because you didn't pay enough tax by the quarterly due date.

The due dates for 2012 quarterly estimated tax payments are as follows: April 15, June 15, September 15, and January 15, 2013. But if you file your 2012 return by February 2, 2013, and include the rest of your tax, then you can skip the January 2013 last quarter payment and enjoy a two-week grace period.

What Income Goes into Calculating Estimated Tax?

If you made money, then you're safe to assume it is taxable income:

- Self-employment income
- Stock sales
- Interest income
- Dividend income
- Alimony received (do not include child support)
- Rental income
- Gains from the sale of assets, such as your residence
- Prizes and awards, including lottery winnings
- Insufficient withholdings from your wages, salary, pension, and so on.

If your employer is already withholding taxes for you, then you may avoid estimated tax by ensuring that your employer withholds enough to cover your full tax liability. To set the amount your employer should withhold from your employment earnings, use IRS Form W-4.

How Do I Know if I Must Estimate Tax? Look Forward, Look Back

First Rule – Look Forward: If you anticipate owing $1,000 or more in taxes when your income tax return is due (that would be April 2013 for the tax year 2012), then you must make estimated tax payments for each quarter during 2012.

Second Rule – Look Back: When you owe income tax for the previous year, you may have to make estimated payments in the current year:

> If your 2011 adjusted gross income was under $150,000 (or under $75,000 if you were married and filed separately);
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> Then your 2012 estimated tax must either be 90% of the current year's tax liability, or be 100% of the tax shown on your 2011 return.

Third Rule – Look Both Ways: The IRS has special rules for higher income earners:

> If your 2011 adjusted gross income was over $150,000 (or over $75,000 if you were married and filed separately);
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> Then your 2012 estimated tax must either be 90% of the current year's tax liability, or 110% of your previous year's tax bill – that is, the tax shown on your 2011 return.

How Do I Know How Much to Pay if I Haven't Earned the Money Yet?

The first step is to think like the IRS and download the correct form, then simply run the numbers. Use IRS Form 1040-ES "Estimated Tax for Individuals" to calculate your estimated tax liability for the 2012 tax year. The time to calculate estimated tax is while you prepare your 2011 returns. The figures you need are readily available and everything is fresh in your mind. Remember, the 2012 first quarter estimated tax payment is due April 15.

The second step is to look to last year's income tax returns. This is an estimated tax, but that doesn't mean you'll get away with a rough estimate or best guess. You need to use all the pertinent information you have to make a realistic (and defensible) estimate of your current tax liability. This means you calculate your expected adjusted gross income, arrive at your taxable income and tax obligation, and make appropriate deductions and use applicable credits. The resulting 2012 estimated tax is then divided by four, which gives you the amount you must pay in every quarter to avoid an underpayment penalty. If you have seasonal work and anticipate slow months, then you may annualize your income and make unequal quarterly payments.

You can make life easier by scheduling manageable payments. Although the year is divided into quarters for estimated tax purposes, you can make smaller payments with greater frequency (weekly, bi-weekly, monthly), so long as you pay the quarterly total to the Treasury Department by the end of each quarter. You also have the option of applying your 2011 tax refund, assuming you have one, to your 2012 estimated tax liability. When you fall behind or miss a quarterly payment, the IRS can charge interest and add penalties.

If you skipped your quarterly estimated tax payments or did not pay enough, for whatever reason, then you may already be dealing with interest, penalties, and the IRS. To learn what your taxpayer rights are when dealing with the IRS, contact an experienced Arizona tax attorney for representation and advocacy. With the right attorney, in many cases, if not most, the interest and underpayment penalties can be reduced or eliminated altogether.

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Lawrence 'D' Pew is an experienced tax, bankruptcy, and transactional attorney, and founder of the Pew Law Center, PLLC – a leading Arizona tax and bankruptcy law firm focused exclusively on debt relief. With offices in Mesa, this law firm serves Arizona residents in the greater Phoenix area, including Scottsdale, Mesa, Tempe, Gilbert, and Chandler. Client-oriented with a mission to always exceed client expectations, the Pew Law Center has helped over 2,000 people file for bankruptcy and eliminate over $100 Million in debt.
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