Planning to Pay Individual Estimated Tax

Some individuals have to pay estimated taxes or face a penalty in the form of interest on the amount underpaid. Self-employed persons, retirees and nonworking individuals most often must pay estimated tax to avoid the penalty. But an employee may need to pay them if the amount of tax withheld from wages is not sufficient to cover the tax on other income. The potential tax owed on investment income also may increase the need for paying estimated tax, even among wage earners.

The trick with estimated taxes is to pay a sufficient amount of estimated tax to avoid a penalty but not to overpay. That's because while the IRS will refund the overpayment when you file your return, it won't pay you interest on it. Individual estimated tax payments are generally made in four installments. For the typical individual who uses a calendar tax year, payments generally are due on April 15, June 15, and September 15 of the tax year, and January 15 of the following year (or the following business day when it falls on a weekend or other holiday).

Generally, you must pay estimated taxes if (1) you expect to owe at least $1,000 in tax after subtracting tax withholding (if you have any) and (2) you expect that your withholding and credits to be less than the smaller of 90 percent of your current year taxes or 100 percent of the tax on your prior year return.

There are special rules for higher income individuals. If your adjusted gross income for your prior year exceeded $150,000, you must pay either 110 percent of the prior year tax or 90 percent of the current year tax to avoid the estimated tax penalty. For married filing separately, the higher payments apply at $75,000.

Estimated tax is not limited to income tax. In figuring your installments, you must also take into account other taxes such as the alternative minimum tax, penalties for early withdrawals from an IRA or other retirement plan, and self-employment tax, which is the equivalent of social security taxes for the self-employed.

Suppose you owe only a relatively small amount of tax? There is no penalty if the tax underpayment for the year is less than $1,000. However, once an underpayment exceeds $1,000, the penalty applies to the full amount of the underpayment.

What if you realize you have miscalculated before the year ends? An employee may be able to avoid the penalty by getting the employer to increase withholding in an amount needed to cover the shortfall. The IRS will treat the withheld tax as being paid proportionately over the course of the year, even though a greater amount was withheld at year-end. The proportionate treatment could prevent penalties on installments paid earlier in the year.

What else can you do? If you receive income unevenly over the course of the year, you may benefit from using the annualized income installment method of paying estimated tax. Under this method, your adjusted gross income, self-employment income and alternative minimum taxable income at the end of each quarterly tax payment period are projected forward for the entire year. Estimated tax is paid based on these annualized amounts if the payment is lower than the regular estimated payment. Any decrease in the amount of an estimated tax payment caused by using the annualized installment method must be added back to the next regular estimated tax payment.

As you can see from this overview, figuring out estimated taxes can be rather complex. Please consult your tax advisor for how these rules may impact you specifically. Your individual circumstances may require further analysis or consideration of how these rules interact with other elements of your overall tax situation.