

How To Avoid Paying Too Much Estimated Tax

By Wayne M. Davies

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Many self-employed people and small business owners make quarterly estimated tax payments at both the federal and state level. (Sigh!)

Now that we're past the year's half-way point, this is a good time to take a look at how much you've paid in so far, and whether you need to make any adjustments to this year's remaining two quarterly estimated tax payments.

NOTE: If you're newly self-employed, and perhaps unfamiliar with the government's estimated tax payment schedule, here are the due dates for the Year 2003 quarterly estimated tax payments:

QTR 1: April 15, 2003
QTR 2: June 15, 2003
QTR 3: September 15, 2003
QTR 4: January 15, 2004

The form used to accompany the payments is Form 1040-ES. You can download the form and its instructions here:

<http://www.irs.gov/pub/irs-pdf/f1040e03.pdf>

By the way, please don't ask me how they came up with these "quarters" -- the first quarter coincides with the calendar quarter, but the other three don't. Two of the "quarters" aren't even three months. Go figure.

Still with me? Good. Let's get down to business.

If your business income fluctuates from year to year, as is often the case for the small business owner, it can be difficult (if not impossible) to know exactly what your tax liability is going to be for the whole year until the year is over.

So many self-employed people end up being too conservative. They fear having a balance due on their tax return and pay way too much estimated tax during the year. They end up just like the W-2 employee who has too much income tax withheld from his/her paycheck. The end result -- the self-employed person also gets a large refund, and has given the IRS an interest-free loan of his hard-earned money. Not good!

The self-employed person has two options to avoid overpayment of estimated tax.

OPTION 1:

Do your best to track your income and expense during the year. If you are running a successful small business, you should be recording your income and expense activity each month, and you should be able to produce reports that tell you exactly how your business is doing each month. Either you are doing this yourself with the help of a software program like Quicken or Quickbooks, or you are paying a bookkeeper or accountant to do this. My point: if you don't know how your business is doing every month, you are making a big mistake!

If you want to be successful, you've got to know where you stand every month profit-wise. If you are waiting until the end of the year to see what the numbers look like, you are mismanaging your business.

You've got to know the "bottom line" each and every month, both from a business management/cash flow standpoint, and also from a tax standpoint. From a tax standpoint, once you know your profit for a given quarter, you can then calculate the resulting tax liability on that quarter's profit, and you can make a reasonably accurate quarterly estimated tax payment instead of just "winging it" and paying too much (or too little).

OPTION 2:

Here's another great way to take care of your quarterly estimated tax payments. Option 2 is what the Tax Code calls "The Safe Harbor Method," defined as follows:

The Tax Code says that most taxpayers can calculate the minimum amount of estimated tax by paying the previous year's tax liability in the current year. Let's say you are trying to figure out how much estimated tax to pay for Year 2003. Let's also assume your Year 2002 federal income tax liability was \$10,000. For Year 2003, you take the \$10,000

and divide it by 4, and you would pay \$2,500 per quarter. That wasn't too hard!

As you can see, this is a much easier method to use than Option 1, because it takes less time to calculate.

There is another advantage to The Safe Harbor Method: if your income (and resulting tax liability) increases in 2003 compared to 2002, you can still pay the Year 2002 tax liability amount in Year 2003 and not incur any penalty or interest for having a balance due on the Year 2003 return.

As long as you pay that Year 2003 balance due by April 15, 2004, then it doesn't matter how much you owe on the 2003 return. You have complied with the "safe harbor" rule for quarterly estimated tax payments.

So Option 2 lets you calculate your estimated tax payment amount in literally seconds, and it also lets you "get away" with paying a minimum amount of tax during the year without any fear of penalty for waiting until April 15 to pay the rest.

Practically speaking, Option 2 is often best for self-employed people whose income remains relatively constant from year to year. If your income dramatically increases one year, keep in mind that you can still pay the previous year's tax liability and hang on to your money for a few extra months, but eventually you will have to come up with that large balance due. If you like waiting until the last possible day to pay your balance due, then Option 2 is for you. Just make sure you "put something aside" to take care of that large balance due.

Also, please notice that I said that "most" taxpayers can pay last year's tax liability to qualify for the Safe Harbor method. If your income is over \$150,000, then the amount of estimated tax you are required to pay is 110% of the previous year's tax liability, not 100%.

Just another example of an exception to the rule.

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Wayne M. Davies is author of the new eBook, "The Tax Reduction Toolkit: 29 Little-Known Legal Loopholes That Will Reduce Your Taxes By Thousands (For Small Business Owners and Self-Employed People Only!) Don't file another tax return until you visit:

<http://www.YouSaveOnTaxes.com/toolkit.html>

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