



SWC Business Brief

Calculating Tax Withholding and Estimated Taxes



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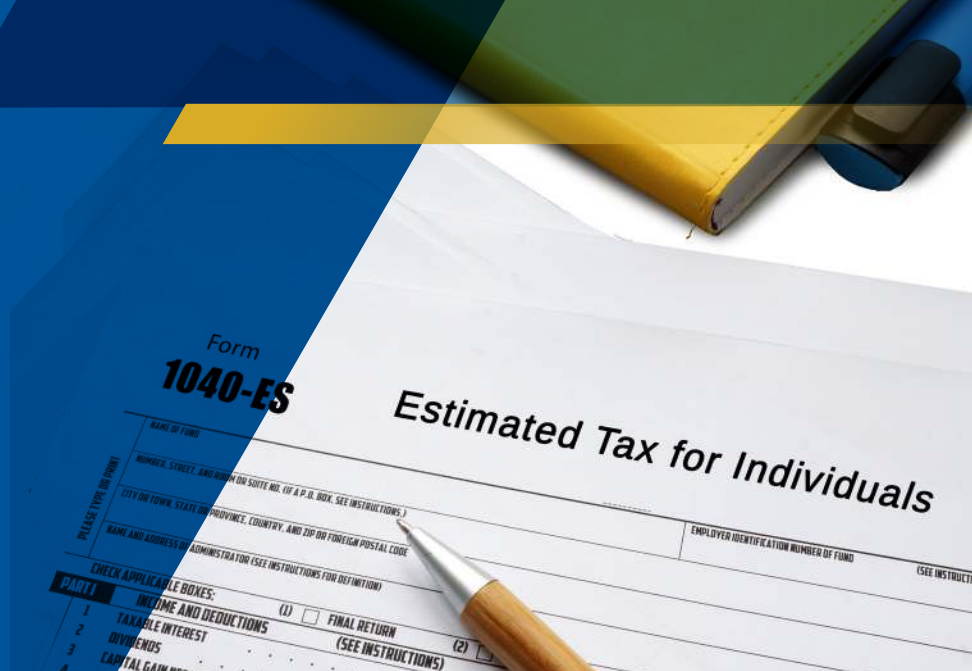
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INTRODUCTION

Calculating Tax Withholding and Estimated Taxes



Nobody looks forward to paying taxes, but it's less painful when tax withholdings are calculated by an employer and automatically withheld from your pay. Much easier than crunching the numbers ourselves and then paying the government out of our savings. Somehow, the latter process feels like we're working for Uncle Sam, and that's not a pleasant feeling.

Here in the United States, ours is a *pay-as-you-go* tax system, meaning we taxpayers are expected and required to pay taxes on our income as we earn it – instead of paying it all at once at the end of the year. Employees have taxes automatically withheld from their paychecks by their employers, which satisfies the taxing authority's requirement.

In contrast, if you're a small-business owner, you face the onerous task of calculating your income and expenses, *estimating* the amount of tax owed on that amount, and cutting checks (or making electronic payments) for the amounts due to state and federal entities. These include the Franchise Tax Board here in California, and/or the Internal Revenue Service (IRS). And, you're required to repeat this process four times a year, to pay your businesses quarterly estimated federal, state, and local taxes.

No one wants to get stuck with a huge tax bill (and penalties) at the end of the year. Nor do we want to overpay, which is essentially giving the government a free loan while leaving

ourselves and our business with less of the money we earned. As small-business owners ourselves, we at SWC feel your pain, so in this *SWC Business Brief*, we lead you through the process of estimating your taxes, hopefully making it a little less painful. But first, we need cover a few preliminary topics.

Understanding Tax Withholdings and Estimated Taxes

According to the IRS, “Taxes must be paid as you earn or receive income during the year, either through withholding or estimated tax payments.” *Withholdings* are taxes an employer collects on behalf of the taxing authorities and sends to them on behalf of the employee. Estimated taxes are generally those paid quarterly based on a business entity’s expected business income. Taxpayers are required to pay estimated taxes in the following situations:

- The amount of income tax withheld from your salary or pension is not enough.
- You receive additional income such as interest, dividends, alimony, self-employment income, capital gains (for example, from selling stock for a profit), prizes, and awards from which taxes have not been withheld.
- You are in business for yourself, in which case the estimated taxes you pay cover not only the income tax you owe but also self-employment tax and alternative minimum tax (if applicable).

If you don’t pay enough tax through withholding and estimated tax payments, you may be charged interest, calculated weekly, on what you should have paid. You also may be charged interest if your estimated tax payments are late, even if you are due a refund when you file your tax return.

To avoid having to pay interest, you must deposit a certain minimum amount by the end of the year:

- If your 2019 Adjusted Gross Income (AGI) was \$150,000 or less, you’ll need to withhold 100 percent of your 2019 tax or 90 percent of your 2020 tax.



- If your 2019 AGI was more than \$150,000, you'll need to withhold 110 percent of your 2019 tax or 90 percent of your 2020 tax.

Estimated taxes are the alternative for small-business owners. With the estimated tax approach, you estimate your total bill, divide the estimate by four, and send quarterly payments to the IRS. As with withholding payments, you owe specific percentages by deadlines set by the taxing authorities. And if you miss any of the deadlines, you'll owe interest on what you should have paid. For 2020, estimated tax due dates are:

- 22.5 percent by April 15
- 45 percent by June 15
- 67.5 percent by September 15
- 90 percent by January 15

Whether you're an employee or self-employed, we encourage you to review your withholding and estimates whenever your tax picture changes, such as in the following cases:

- You get married or divorced
- You have a baby (or adopt)
- You or your spouse takes a new job
- You or your spouse gets a raise
- You buy or sell a house
- You sell *appreciated property* (real, personal, or intangible assets having a fair market value greater than their original cost)

If you're an employee, you can change your withholding by submitting an updated Form [W-4](#) to your employer. If you're self-employed, you'd use Form [1040-ES](#) to calculate and pay quarterly estimated taxes. You may also find the following IRS publications useful:

- [IRS Publication 505: Tax Withholding and Estimated Tax](#)
- [IRS Publication 919: How Do I Adjust My Tax Withholding?](#) (PDF File)



Who Must Pay Estimated Tax

The bar is low for determining who's required to pay quarterly estimated taxes. That said, you're required to pay estimated tax if you meet any of the following conditions:

- An individual who's a sole proprietor, partner, or S corporation shareholder and expects to owe \$1,000 or more in federal tax upon filing the annual federal tax return.
- A corporation that expects to owe \$500 or more in federal tax upon filing the annual federal tax return.
- An individual who owed taxes in the prior year *may* be required to pay estimated tax for the current year.

If you're unsure whether you're required to pay estimated tax, ask us using the [Contact information](#) on our website, or if you're one of those do-it-yourselfers, see [Form 1040-ES, Estimated Tax for Individuals](#) or [Form 1120-W, Estimated Tax for Corporations](#).

If you operate your business as a corporation, you can draw income through the year in the form of loans, then convert the loans into income (and withhold the resulting tax) in a single lump sum at the end of the year.



Who Doesn't Have to Pay Estimated Tax

You don't have to pay estimated tax for the current year if you meet **all three** of the following conditions:

1. You had no tax liability for the prior year, meaning your total tax was zero or you didn't have to file an income tax return for the prior year.
2. You were a U.S. citizen or resident for the whole year.
3. Your prior tax year covered a 12-month period.

If you're an employee receiving salaries and wages, you can avoid paying estimated tax by asking your employer to withhold

more tax from your earnings. You make such a request by filing a new [Form W-4](#) with your employer. Form W-4 has a line on which you can specify the additional amount you want your employer to withhold.

If you receive a paycheck, you can use the IRS's Tax Withholding Estimator to be sure you have the right amount of tax withheld from your paycheck.

How to Calculate Your Estimated Tax

In the following sections, we present a nine-step process for calculating your estimated tax for any given quarter of the year, assuming you're a small-business owner (and not an employee).

Step 1: Estimate your annual business income.

The easy way to estimate your annual business income is to look at last year's income, then compare your total business income from last year at this time to your total business income so far this year and make a reasonable projection about this year's income.

For example, suppose you're nearing the end of the second quarter.

- Your business pulled in \$150,000 last year, \$70,000 of which was earned by the end of the second quarter.
- This year, you've already earned \$80,000 by the end of the second quarter, so you're pretty sure you're going to earn more than last year, probably at least \$10,000 to \$20,000 more.

You decide to play it safe and estimate high, so you project that your business will pull in \$170,000 this year.

Step 2: Estimate your annual business expenses.

Repeat Step 1, but this time, look at your total business's *expenses* from last year, then compare your total business expenses from last year at this time to your total business expenses so far this year, and make a reasonable projection about this year's expenses.



For example, suppose:

- You had \$30,000 in business expenses all of last year, \$17,000 of which you spent by the end of the second quarter.
- This year, you've spent \$20,000 to cover the first and second quarter's business expenses, which is \$3,000 more than you spent during the first half of last year, so you project that you'll probably spend at least \$3,000 to \$6,000 more than last year.

You decide that \$6,000 is probably more accurate, so you expect to spend \$36,000 by the end of this year.

Step 3: Estimate your taxable business income (and ultimately your total income).

You project that your business will pull in \$170,000 this year and spend \$36,000 to cover business expenses, so, $\$170,000 - \$36,000 = \$134,000$, which is your projected business income for the year. (Note: This is where you stop to calculate self-employment tax, which is Step 5 below.)

Now, subtract \$12,200 (your standard deduction for a single taxpayer).

If you and your spouse own and run the business together and are filing jointly, subtract \$24,400.

Assuming you take the standard deduction for a single taxpayer, that knocks your business income down to $\$134,000 - \$12,200 = \$121,800$.

If you itemize deductions, this is when you would estimate all of your itemized deductions and reduce your taxable income by that amount. For the sake of ease, we are using the standard deduction for examples.

Assuming your business income is all your income for the year, that \$121,800 is a good ballpark estimate of your adjusted gross income (AGI).



Once you have resolved what your business income is, it would now be time to add in all other taxable income such as wages, interest, dividends, etc. For the sake of this example, we are assuming that your business is all of your income.

Step 4: Calculate your projected total income tax for the year.

Calculate the tax due on your total business income based on the current year's tax tables. For example, for single taxpayers, 2020 tax rates are as follows:

- 10 percent on the first \$9,875
- 12 percent on income ranging from \$9,876 to \$40,125
- 22 percent on income ranging from \$40,126 to \$85,525
- 24 percent on income ranging from \$85,526 to \$163,300

To continue our example, the federal tax on \$121,800 would look like this:

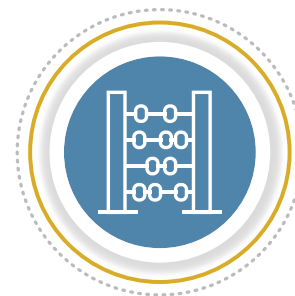
- 10 percent of \$9,875 = $0.10 \times \$9,875 = \98.75
- 12 percent of $\$40,125 - \$9,875 = 0.12 \times \$30,250 = \$3,630$
- 22 percent of $\$85,525 - \$40,125 = 0.22 \times \$45,400 = \$9,988$
- 24 percent of $\$121,800 - \$85,525 = 0.24 \times \$36,275 = \$8,706$

So, the total tax would be $\$98.75 + \$3,630 + \$9,988 + \$8,706 = \$22,422.75$

Step 5: Calculate your self-employment tax.

To calculate self-employment tax, multiply *total business income* (before subtracting for your standard deduction) by 92.35 percent, then multiply the result by 15.3 percent, which is the total of Social Security tax (12.4 percent) and Medicare (2.9 percent).

- In our example, $92.35 \text{ percent} \times \$134,000 = \$123,749$, and $\$123,749 \times 0.153 = \$18,933.60$.



Step 6: Calculate your total federal tax.

Add your income tax and self-employment tax together to determine your total estimated tax for the year.

- In our example, the total projected annual tax would be $\$22,422.75 + \$18,933.60 = \$41,356.35$.

Step 7: Subtract the federal tax you paid so far.

- Subtract any quarterly estimated federal tax payments you already made this year and any refund from last year's taxes you applied to this year's federal taxes from the total in Step 6. For example:
 - If you applied \$1,000 in refund from last year's taxes and paid \$8,000 in first quarter estimated taxes, that's \$9,000.
 - In our example, the total projected federal tax remaining for the year would be $\$41,356.35 - \$9,000 = \$32,356.35$.

Step 8: Calculate your remaining quarterly payments.

Next, divide the result in Step 7 by the number of remaining quarterly payments to estimate the amount of each of the remaining payments. In our example, this is the second quarter, so including the second quarter payment, we're looking at three remaining payment periods, so divide the total from Step 7 by three: $\$32,356.35 \div 3 = \$10,785.45$.

Step 9: Calculate your state and local taxes.

Finally, repeat Steps 1-8 to calculate your state and local taxes. The only variation in the process is the tax rate(s) you use in Step 4 and the fact that you skip Step 5 because you won't owe self-employment tax at the state and local levels.

Paying Estimated Taxes on Time

To avoid penalties, you must pay your estimated taxes on or before specific due dates. For estimated tax purposes, the year is divided into four payment periods, which are typically as follows:



- 1st Quarter – April 15
- 2nd Quarter – June 15
- 3rd Quarter – September 15
- 4th Quarter – January 15

Most states that collect income tax impose the same deadlines as the IRS. To boost your current year's itemized deductions, prepay your fourth quarter estimate this year to claim the deduction on next year's return. If you wait until next year to pay, you'll have to wait until the following year to claim the deduction. When using this approach, keep in mind that there's a \$10,000 annual limit on deducting state and local taxes as itemized deductions.



Easy? Not necessarily. We are here at SWC to help you with these calculations!

Disclaimer: *The information in this SWC Business Brief about calculating tax withholding and estimated taxes is provided for general informational purposes only and may not reflect current financial thinking or practices. No information contained in this business brief should be construed as financial advice from the staff at Stees, Walker & Company, LLP (SWC), nor is this the information contained in this business brief intended to be a substitute for financial counsel on any subject matter or intended to take the place of hiring a Certified Public Accountant in your jurisdiction. No reader of this business brief should act or refrain from acting based on any information included in, or accessible through, this business brief without seeking the appropriate financial planning advice on the particular facts and circumstances at issue from a licensed financial professional in the recipient's state, country or other appropriate licensing jurisdiction.*