Lower Your Quarterly Estimates Without Penalties

Publisher: ***ISU*\Information Services Unlimited**

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The referenced sections are from ***The Renaissance Goldmine of Goldmine of Brilliant Tax Strategies Real Estate Investor's*, A Tax Reduction Software System by Albert Aiello & Bill Noll. For more info go to https://TractionREIA.com/al**

This is part of a good organized plan. In this report the following, along with planning strategies, are discussed:

A. NOT PROPERLY FILING ESTIMATED TAXES COULD BE *COSTLY*!

B. FIRST, SOME BASIC RULES

C. TWO EXCEPTIONS, WITH STRATEGIES, TO PREVENT PENALTIES SO YOU CAN PAY LESS ESTIMATED TAXES AND HAVE SOONER USE OF YOUR MONEY

D. OTHER ESTIMATED TAX STRATEGIES

E. OTHER POINTERS ABOUT ESTIMATED TAXES

F. SMART *MONEY-MANAGEMENT* FOR YOUR QUARTERLIES

A. NOT PROPERLY FILING ESTIMATED TAXES COULD BE *COSTLY*!

One self-employed person that I know is being plagued with over $25,000 in past taxes, interest and penalties because he did not keep up with his estimates. Just the worry about it is also interfering with his ability to produce income. I sent him to a top IRS Tax Specialist who may be able to reduce this burden for him. However, depending on last minute “Hail Mary” passes is certainly not smart money management.

B. FIRST, SOME BASIC RULES

1. General rule: Self-employed individuals who earn income are required to file and pay quarterly estimated taxes. However, because of certain IRS safe harbors, you frequently are not required to pay estimated taxes in the following situations for the year:

1) You do not receive any income at all.

You receive income but there are expenses to offset it that results in net income* of $400 or less, or a tax loss. [*Note: Estimated taxes are due on income *after* expenses (i.e. "Net" income) and not on "Gross" income, which is income before expenses]

2) You receive net income of $400 or more. However, on your own return or on a joint return through your spouse's withholding (or estimated taxes), you pay in at least 100% of last year's tax liability. (This is a "Safe Harbor". See Strategy 1 on the next page)

3) Your total tax liability, after withholdings, will be less than $1,000.

Once you are outside of any of these situations, start filing estimates and adhere to the following rules and strategies.

2. Filing: According to Internal Revenue Code Section 6654, estimated tax payments for individuals are filed with IRS Form 1040-ES on a quarterly basis as follows:

Due Dates for Quarterly Estimates	**Quarter Covered by Payment**
April 15..	First quarter
June 15...	Second quarter
September 15...	Third quarter
January 15 (of the following year) *............	Fourth quarter

*NOTE: You can skip the fourth quarter payment if you filed your tax return and paid the taxes owed by January 31. TIP: However, I do not recommend filing this early because you should file an extension as discussed in Section 20.

3. Federal taxes included: The estimates include federal income tax, Social Security (self-employment) tax and alternative minimum tax (AMT) combined as one quarterly estimate. Withholdings from paychecks count toward estimated payments.

4. Penalties for underpayment: To avoid an underpayment penalty the estimates are to be filed on an *equal* quarterly basis. Increasing an installment payment cannot make up for an under-payment in a prior quarter. (But increasing withholdings will. See Strategy 2 on the next page.) The amount of underestimated penalties for individuals and corporations is recalculated by the Treasury Department each quarter and is tied into the current rate on US government short-term bonds. IRC 6621. Currently, the underpayment penalty rate is 6% for all taxpayers except large corporations who must pay 8%. Rev. Rul. 2000-16. For the current rate, check with competent tax counsel or IRS Form 2210 for individuals or 2220 for corporations. (For further strategies to avoid penalties, see later in this section.) If you did not make the required quarterly estimated payments (including withholding), individuals file IRS Form 2210 with their 1040, or corporations file form 2220 with their 1120. These forms are "brain surgery" to do manually, but a snap with a tax preparation computer program such as *TurboTax*.

C. TWO EXCEPTIONS, WITH STRATEGIES, TO PREVENT PENALTIES SO YOU CAN PAY LESS ESTIMATED TAXES AND HAVE SOONER USE OF YOUR MONEY

<u>**EXCEPTION 1**</u>: Pay in a 100% of your last year's "total tax" if your last year's total tax liability is *lower* than this year's total tax liability. In other words, this works best when your current year's tax liability is *higher* than your previous year's. Under this first exception, if you pay estimated taxes of at least 100%* of your previous year's total tax liability (before withholding) you will prevent penalty. Your total tax liability is called "total tax" and usually appears around line 53 or 54, page 2 of IRS Form 1040.

*<u>NOTE</u>: If your Adjusted Gross Income (AGI) exceeds $150,000 ($75,000 married filing separately) your estimated tax payments and withholding must be 110% (not 100%) of the prior year's total tax liability. This percentage (110%) can change from year to year. Check a current issue of IRS publication 505 or with a tax advisor.

<u>**STRATEGY 1**</u>: **Follow exception 1 when your current year's tax liability is *higher* than your previous year's --**

<u>EXAMPLE 1-- STRATEGY 1</u>: Because you are highly successful, you anticipate having a big jump in income (and tax) from one year to the next. You need it for growth as an entrepreneur. Assume your AGI is under $150,000. Pay in just enough estimated tax for the high-income year to equals 100% of the total (lower) "total tax" on your *prior* year's 1040 (page 2). This will give you the opportunity to put the taxes in an income producing asset (covered later in this section). In the meantime, you still avoid any underpayment penalty in the high-income year, provided that the estimated amounts are paid equally in each quarter.

Assume that the total tax on your last year's 1040 was $3,000. This year you are having a banner year. You therefore expect a significant increase in income and estimate that your total federal tax liability will be higher at about $15,000. Pay in the $3,000 as either quarterly estimates ($750 a quarter) or during the year as withholding from your spouse's salary*. In the meantime, the remaining $12,000 can be put into income producing investment vehicles (covered later in this section) until you have to pay the IRS the following April or a about a year and three months later.

*** <u>STRATEGY 2</u>**: **Use W-2 withholding to prevent penalties** -- If you or your spouse receive W-2 salaries, you can request that the employer withhold the entire $3,000 in December paychecks. You can even give your employer the check to cover the taxes. Unlike quarterly installments, the withholding is treated as if it occurred ratably over the course of the year. Alternatively, the $3,000 may have already been withheld during the year.

<u>THE RESULT</u>: Either way, you avoid penalties *plus* during the year you can earn interest on the estimated taxes.

<u>TIP</u>: The same rule applies to withholding taxes from retirement plans.

<u>EXCEPTION 2</u>: Pay in 90% of your current year's tax if your current year's total tax liability is lower than last year's total tax liability. Under this second exception you pay in at least 90% of the projected total tax liability for the current tax year. If you do so, you will again prevent penalties.

STRATEGY 3: **Follow exception 2 and do not pay in as much as you did in the higher-income prior year --**

EXAMPLE 2 -- STRATEGY 3: You anticipate the opposite of the above -- your income and total tax will be lower than the prior year (which was higher). Then do not pay in as much as you did in the higher-income prior year. Instead, through good business organization, carefully monitor your actual income and deductions during the current year to make certain that your estimated taxes or withholding equal at least 90% of the total tax federal liability for the current tax year. Assume that the total tax liability on your last year's 1040 (on page 2) is $15,000. This year you are having an unusually off year. You therefore expect a significant decrease in income and estimate that your total federal tax liability will be about $3,000 (lower than this year's tax liability.) Pay in 90% of this amount or a total of $2,700 as quarterly estimated taxes or as withholding through W-2 salaries as explained above.

The result: You do *not* overpay, yet you prevent penalties. Moreover, you have the important use of the money to help you get back in gear again.

Filing: When using the above exceptions to prevent penalties, file IRS Form 2210 with your current 1040. For corporations, file IRS form 2220 with the corporate return.

STRATEGY 4: **Get a waiver of penalties for hardship, retirement, disability** -- If you failed to make timely estimated payments because of casualty, disaster or other unusual circumstances, the IRS may waive the penalty, Internal Revenue Code Section 6654(e)(3). The IRS may also abate the penalty if you retired after attaining age 62 or became disabled and you did not make a payment because of reasonable cause and not due to willful neglect. To request the waiver of penalty attached a detailed letter with supporting documentation (such as a medical report or letter from a doctor) to IRS form 2210 for individuals or IRS form 2220 for corporations. See also my "*IRS Penalty-Killer Packet*" on the Bible disk.

If you own a seasonal business where your income varies substantially during the tax year, you may be able to reduce or eliminate some or all of the quarterly penalties by using the annualized income installment method to compute the penalties. Refer to the instructions for IRS form 2210 for individuals or IRS form 2220 for corporations. These forms should be completed for all of these scenarios. They are not difficult to do with a tax preparation computer program such as *TurboTax*.

D. OTHER ESTIMATED TAX STRATEGIES

STRATEGY 5: Do not apply a refund for estimated taxes -- Instead take the refund in cash and pay any estimates *separately*. *Reason*: If you made an error on your return and owe taxes you just cannot tell the IRS to take it from the refund. They will apply the refund toward the estimated taxes. You will have to come up with the money for the taxes owed out of your own pocket and may get hit with a penalty.

STRATEGY 6: Avoid big refunds -- One obvious disadvantage of a big refund is letting the IRS have the interest-free use of your money. This is enough reason to avoid it. But there is another -- the IRS can withhold all or part of your refund to offset a prior or current year's tax liability. They can do the same for other non-tax liabilities, such as unpaid child support or a debt to a government agency, such as a student or SBA loan.

STRATEGY 7: Never allow a refund check to be sent to your preparer's address -- It should go to your address.

E. OTHER POINTERS ABOUT ESTIMATED TAXES

1. Reminder: Your spouse's withholding (or estimated payments) count toward the above estimated payments in preventing penalties.

2. Payment by credit card: You may charge estimated tax payments with the IRS using Visa, MasterCard, Discover or American Express. See IRS Form 1040ES for instructions. If you do charge your estimated payments, you do not have to file 1040ES vouchers.

TIP: However, I would check if there are any additional IRS "convenience" charges (or other "bureaucratic" hassles) for using your credit card.

3. State estimated income taxes: Many states have rules for estimated taxes that are the same and "piggyback" to the federal. But you should make sure and check the laws of your state.

4. Corporations: Like individuals, corporations are also required to make estimated tax payments (form 1120W). Generally, the corporation is subject to an under estimated penalty if it has a tax liability of $500 or more for the current year and did not timely pay, in quarterly payments, at least the *lesser* of the following: (1) 100% of the tax liability for the current year or (2) 100% of the tax liability for the previous year The previous year is only taken into account if the corporation filed a tax return for the previous year showing at least some taxes due. See Internal Revenue Code Section 6655(d).

5. More information on estimated taxes: Refer to IRS publications 15A (*Employer's Supplemental Tax Guide*), 505 (*Tax Withholding and Estimated Tax*) and 533 (*Self-Employment Tax*).

F. SMART *MONEY-MANAGEMENT* FOR YOUR QUARTERLIES

You have got to discipline yourself to budget and set aside funds for your quarterly estimates. Otherwise you may be borrowing to pay your taxes, and this is poor money-management. In fact, it could end up as a financial disaster. I know quite a few self-employed individuals who overextend themselves with huge credit card and auto lease payments. As a consequence, they cannot pay their IRS (and state) quarterlies. They end up losing their car, their good credit along with IRS penalties, interest, wasted time, and a lot of stress. A perfect example is the person that I mentioned in the very beginning of this section. DON'T LET THIS BE YOU!

One way to set aside funds for your quarterlies is through withholding. If you (or your spouse) also receive W-2 income, then have enough withheld to at least cover the minimum requirements as per Strategies 1 and 3 of this section. You can even do this in the last month of the current tax year as per Strategy 2.

<u>STRATEGY 8</u>**: Open up a separate savings\checking account just for taxes** -- The savings\checking account should be interest-bearing from which you can write checks. <u>It should only be for paying taxes</u>. Keep some excess funds as a back-up. Remember, it's interest-bearing.

<u>STRATEGY 9</u>**: Pay from income checks** -- If you work for someone on a steady basis, but as an independent contractor, when they pay you for the job, ask them to cut two checks -- one for you and the other to your savings account set aside for taxes, as per the above. You may even be able to do this as a direct deposit to your account. As a rule of thumb, you should set aside

20 to 25% of the total income for taxes. Make sure it goes directly into the savings account.

For example, assume you are a real estate agent and considered an independent contractor. When your broker pays you your commission, ask them to cut two checks -- one for you and the other to your savings account set aside for taxes.

STRATEGY 10: **Invest in higher interest vehicles** -- Once funds start to accumulate in the savings account you can purchase one-year Treasury bills ("T-bills") four times a year to fund the next year's quarterly payments. T-bills are sold in denominations of $5,000 for terms as short as 3 months. Typically, the yield is 1 to 2 percent higher than bank interest. You could also try short term CD's. Shop around. One local bank I know had a higher yielding CD, with only a minimum $1,000 requirement and you can withdrawal any time without penalty. If you are a high-income entrepreneur look to invest in tax-free municipal bonds or tax-free money markets. In a 40% tax bracket, a 3-1/2% tax-free rate equates to about a comparable 5.8% taxable yield.