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Tax Withholding & Estimated Payments: Staying on Track All Year Long

Matthew Licata – Financial Planning Associate

When it comes to taxes, most people focus on what happens in April. But in reality, the work that determines whether you owe a balance or receive a refund occurs throughout the year. Understanding how tax withholding and estimated payments work can help you stay on track with your tax liability and avoid surprises when you file. This is particularly relevant for households with multiple income sources, such as retirees, business owners, and professionals with bonuses or investment income.

WHAT IS TAX WITHHOLDING?

Tax withholding is the amount of federal (and often state) tax that is automatically taken out of your income before it ever hits your bank account. This commonly applies to:

- Wages and salaries
- Bonuses
- Pension income
- Social Security (if elected)
- Certain retirement plan distributions

Withholding is essentially a “pay-as-you-go” system, meaning the IRS expects you to pay taxes as income is earned, and not all at once when you file your return.

ARE YOU REQUIRED TO WITHHOLD TAXES?

Technically, you are not required to have taxes withheld from every income source. However, you are required to pay enough tax throughout the year to meet IRS safe harbor rules.

If you do not meet those thresholds, you could be subject to underpayment penalties. As of now, the IRS underpayment penalty rate for individuals is approximately 7% and is adjusted quarterly, which makes proactive planning especially important. Out how any of these numbers may affect your financial strategy, we're here to help.

UNDERSTANDING SAFE HARBOR RULES

You can generally avoid underpayment penalties if you meet one of the following:

- You pay at least 90% of your current year tax liability, or
- You pay 100% of your prior tax liability (or 110% if your income exceeds certain thresholds)

This is why two people can have the same tax bill and have different outcomes. One may have no penalty, while the other may face interest and penalties.

WITHHOLDING VS. ESTIMATED PAYMENTS

For individuals with wages, withholding is often the simplest and most effective way to stay on track. For others, especially retirees, business owners, or those with investment income, estimated quarterly payments may be necessary.

Estimated payments are typically used when income is irregular or seasonal, not subject to withholding, or driven by investments, rentals, or pass-through businesses.

From a planning perspective, withholding often provides more flexibility than quarterly estimated payments. That is because withholding is treated as if it were paid evenly throughout the year, even if adjustments are made late in the year. This feature can be especially useful when income changes unexpectedly or becomes clearer later in the year, making withholding a powerful planning tool.

IS OWING AT TAX TIME A BAD THING?

Owing money when you file does not automatically mean something went wrong. In many cases, it simply means your money stayed in your control longer instead of being sent to the IRS early.

As Patty Lavoie (Grimes Financial Advisor, CPA, CFP®) put it:

“Having a balance due when you file is not a concern as long as it was planned for and does not result in an underpayment penalty. Depending on your annual income, the withholding on your wages or retirement distributions may be covering 90% of the current year tax liability or 100%/110% of your prior year tax liability which would make you exempt from underpayment penalties. It is important to connect with your tax advisor to confirm if estimated tax payments or withholding is sufficient or if it should be adjusted, especially if you have significant changes to your taxable income from year to year.”

The key distinction is whether the amount owed triggers penalties, and whether the cash retained during the year worked productively for you.

HOW TO APPROACH WITHHOLDING STRATEGICALLY

A thoughtful withholding strategy should consider all sources of income, whether that income is growing or declining, current interest rates and opportunity cost, cash flow needs throughout the year, and exposure to underpayment penalties.

Rather than aiming for a large refund or intentionally underpaying, the objective is often to align payments as closely as possible with actual tax liability, while maintaining a sufficient cushion to remain penalty-free.

BRINGING IT ALL TOGETHER

Tax withholding and estimated payments are not about perfection, but rather about balance. With proactive planning and periodic check-ins during the year, you can reduce the risk of penalties, improve cash flow management, and avoid unnecessary surprises at filing time.

As with most areas of financial planning, the right approach depends on your full financial picture. Reviewing withholding annually, or when income changes, can help reinforce discipline and provide greater peace of mind over time.

For many households, a brief [conversation with a Grimes & Company advisor](#) can help confirm whether current withholding or estimated payments remain aligned with evolving income, cash flow, and planning priorities. These discussions are less about making changes and more about ensuring that existing strategies continue to support long-term goals without introducing unnecessary tax friction.

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