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Understanding Estimated Taxes

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As tax deadlines approach, many people wonder if they should be making estimated tax payments. If you earn money that doesn't automatically have taxes taken out — such as self-employment income, rental income, or investment income — you may want to consider paying estimated taxes. The IRS, and many states, expect you to pay your taxes as you earn the income. If you don't pay enough throughout the year, you may face penalties and interest, even if you pay your full tax bill by your tax filing deadline. The IRS calculates underpayment penalties based on the amount underpaid and the period it remained unpaid, using interest rates that adjust quarterly. Making quarterly estimated payments, or adjusting tax withholding, can help you avoid surprises and better manage your cash flow.

WHO NEEDS TO PAY ESTIMATED TAXES? HOW TO FILE AND PAY?

If you expect to owe at least $1,000 in taxes when filing your return, you may want to consider making estimated tax payments. To avoid underpayment penalties, the IRS offers a safe harbor rule: you won't be penalized if your payments cover at least 90% of your current year's tax liability or 100% of last year's tax liability (110% if your AGI is over $150,000). Many states follow similar rules, so check with a CPA or your state's tax department for specifics.

The IRS provides Form 1040-ES (for individuals) to estimate tax liability. Estimated payments are due quarterly—generally, on April 15, June 15, September 15, and January 15 of the following year. Individuals with income that fluctuates significantly at different times throughout the year may want to work with their CPA on a quarterly basis to determine the payment amounts required. The IRS provides the option to pay online, by phone, or by mailing a check with a payment voucher. More details are available at www.irs.gov/pub/irs-pdf/f1040es.pdf.

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CASE STUDY: WHEN WITHHOLDING IS NOT ENOUGH

John and Jane are recently retired. Now that they have stopped working, their taxable income consists of IRA distributions, Social Security, and interest, dividends and capital gains from their investment accounts. They have taxes withheld on their IRA distributions and Social Security income. When they receive their tax returns from their new CPA, they note a total tax liability of $35,000 and balance due of $5,510, which included a $90 "estimated tax penalty". They request a meeting with the CPA to discuss the penalty and what they can do to avoid penalties in the future.

The CPA explains that although they had withholding on their Social Security benefits and IRA distributions, there was no withholding applied to their investment income, which had increased significantly from the prior year. As a result, they had a tax due of $5,420. Since they did not pay tax on those investment earnings throughout the year, the IRS assessed an underpayment penalty, which was calculated to be $90.

In order to avoid penalties for 2025, the CPA recommends that they either pay 110% of their 2024 tax liability, since their AGI was over $150,000, or 90% of their expected tax liability for 2025. They can do this via quarterly estimated tax payments, increased withholding on their IRA distributions, or a combination of the two.

With the help of their CPA, John and Jane decide to proceed with a combination of estimated tax payments and increased withholding to be sure that they pay 110% of their 2024 tax liability, or $38,500. They know the withholding on their IRA and Social Security distributions will total $30,500, so they will make estimated tax payments of $2,000 per quarter to account for the $8,000 shortfall. By adjusting their approach now, John and Jane can ensure they meet IRS requirements and avoid penalties when they file their 2025 tax return.

CONCLUSION:

While we often think that only self-employed individuals and small business owners need to make estimated tax payments, any person with significant taxable income that is not subject to withholding may need to consider paying them to avoid penalties. Planning ahead and making timely payments helps to avoid penalties and keeps your finances in order. Your Grimes & Company advisor can collaborate with you and your tax professional to project your income for the current year, helping to minimize the risk of underpayment penalties when you file your return.

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