Estimated Taxes: What New Business Owners Need to Know to Stay Out of Hot Water

As a new business owner you have myriad things to worry about, but perhaps none cause more headaches than taxes. From itemized deductions to self-employment tax, to payroll taxes for those small businesses with employees, issues of taxation are commonplace and worries can be a plenty. But, there is perhaps one tax issue that has a tendency to catch even the most financially-inclined new business owner by surprise- estimated taxes. Understanding what they are, why they matter, and how and when to pay them is imperative to ensuring that you won't be paying unnecessary penalties to Uncle Sam come April.

What Are Estimated Taxes?

At a basic level, estimated taxes are taxes paid on income that is not already subject to withholding. Anyone who is subject to them must make four periodic payments to the IRS each year. So why haven't you heard of them? When you work for an employer, your pay check reflects taxes that have been withheld. Your employer is actually paying those taxes to the IRS periodically- it all just happens without you knowing because, well, there wouldn't be any reason you needed to. But, when you start your own business- whether as a sole proprietor, partnership, S corporation, LLC, or C corporation, your wages are no longer being withheld and periodically paid to the IRS by your employer. It's now up to you to make those payments on behalf of your business.

Do You Need to Pay Estimated Taxes?

Generally, if you are self-employed in any form you must pay estimated taxes if you expect to owe more than $1,000 total in tax when you file your return in April. For business owners that report taxes on a corporate level- whether as a non-disregarded LLC or C Corporation, you typically have to pay estimated taxes if you anticipate having to pay more than $500 when you file your corporate return.

Of course, there are exceptions to the general rules. For one, if your small business is only a secondary means of income for you and you receive salary and wages as an employee with another business, you can ask your employer to withhold more tax from your earnings by filing an updated W-4 with the employer. Requesting that an additional amount equal to your tax liability from your small business be withheld will eliminate the need to file estimated taxes for the business.

You also do not have to pay estimated taxes if you meet three specific requirements: 1) you had no tax liability for the prior year; 2) you were a U.S. citizen or resident for the whole year; and 3) your prior tax year covered a 12 month period.

How Much Do You Need to Pay in Estimated Taxes?

This is where things become a bit challenging. After all, a common challenge for many small businesses is predicting cash flow with specificity. To determine your estimated tax, you first must determine your *expected* adjusted gross income, your taxable income and any deductions or credits for the year. After taking deductions and applying exemptions and credits, and applying the appropriate applicable rate, you'll be left with your estimated tax liability for the year. Unlike other taxpayers, you'll need to split this amount into four equal payments and pay them periodically throughout the year. The IRS will consider you to meet its requirements for estimated tax payments so long as that amount (or more accurately, the amount you actually pay) equals at least 90 percent of your actual eventual total tax bill. In the event that you don't hit that magical 90 percent threshold, you may be required to pay penalties.

Due to the inability of many business owners to estimate their total income and tax liability with such certainty, there is a second option. By using the IRS "safe harbor" rules, you can figure your tax liability and estimated payments based on your liability for the previous year and stay out of trouble. You won't be penalized if you make payments equaling 100% of your liability for the prior year (broken into four equal payments).* This "safe harbor" calculation is attractive to newer business owners that still don't have enough of a gauge on expected annual growth, or cash method businesses in industries where high accounts receivable don't necessarily lead to predictable payments.

When Do You Need to Pay Estimated Taxes?

Estimated tax filings must be made four times a year in order to avoid late payment or underpayment penalties:

- April 15
- June 15
- September 15
- January 15 (of the next year)

Each payment is for the period preceding it.

*The calculations under the safe harbor become a little more complex for earners with AGI over $150,000.

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