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Projecting Federal Income Tax, Making Estimated Payments, Choosing Correct Withholding Amount

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What is it?

The federal income tax is, in the words of the IRS, a pay-as-you-go tax. You pay federal income tax as you earn or receive income during the year, not retroactively. There are two methods for paying as you go: withholding and estimated tax. Withholding occurs when your employer or other payer withholds income tax from your salary, tips, pension, gambling winnings, and unemployment compensation, among other payments. Estimated tax involves making four tax payments during the year in situations in which you either don't have any tax withheld from the income you receive, or you don't have enough tax withheld to cover what you anticipate owing.

If you underpay your tax (whether through insufficient withholding, insufficient estimated tax payments, or a combination of the two), you may owe a penalty. Therefore, you need to project your anticipated tax for the year in order to withhold a sufficient amount or make adequate estimated payments to avoid penalty.

Making estimated tax payments

Under what circumstances do you pay estimated tax?

You pay estimated tax on income that isn't subject to withholding, including income from self-employment. You may also have to pay estimated tax if not enough tax is being withheld from your salary, pension, or other income.

Calculating your estimated tax payments

You must arrive at three figures for the current tax year:

- Your expected adjusted gross income
- Your expected taxable income
- Your expected taxes and credits

These three figures enable you to determine your total expected tax for the current year.

How to figure your installment payments

There are two methods for determining your estimated tax payments: the regular installment method and the annualized income method. Typically, the installment method is easier to use. However, in some cases, annualizing your payments may reduce or eliminate penalties for underpaid periods.

When to pay estimated tax

You make your estimated tax payments in four installments covering four payment periods.

Situations in which you don't have to make estimated tax payments

If either of the following scenarios applies after you've done your calculations, you don't have to make estimated tax payments:

- (1) You expect to owe less than \$1,000 in tax for the current year, after subtracting your withholding and refundable credits
- (2) You expect your withholding and refundable credits for the current year to be at least:
 - 90 percent of your total expected tax for the current year or, if smaller,
 - 100 percent of the tax shown on your prior year's tax return (your prior year's tax return must cover all 12 months)

Caution: *Special rules apply to certain farmers and fishermen, and certain higher income individuals.*

Tip: *If all your income will be subject to income tax withholding, you probably do not need to pay estimated tax.*

How to pay estimated tax

There are four ways you can make estimated tax payments:

- Crediting an overpayment on one year's return to your following year's estimated tax
- Sending in your payment with a payment voucher from Form 1040-ES
- Paying electronically using the Electronic Federal Tax Payment System
- Paying by credit card

Choosing the correct withholding amount

Choosing the correct withholding amount on your salary or wages (or perhaps tips, taxable fringe benefits, pensions and annuities, or unemployment compensation) may enable you to avoid paying estimated tax or a penalty.

Determining the amount of tax withheld

Two factors determine the amount of income tax your employer withholds from your regular pay:

- The amount you earn
- Information you provide your employer on Form W-4

Tip: *If your income is sufficiently low, you may be entirely exempt from withholding.*

Getting the right amount of tax withheld

If you accurately complete all Form W-4 worksheets and provide an updated Form W-4 when circumstances change, it is likely your employer will withhold an amount close to the tax you owe on your return.

Tip: *Get a copy of Publication 919 to help you determine the correct amount you should have withheld given your circumstances.*

Caution: *If you have less than the correct amount withheld, you may need to make estimated tax payments.*

Exemption from withholding

Under certain circumstances, you can claim exemption from withholding. If you are a student, though, don't assume that you are automatically exempt--you're not. See IRS Publication 17, Your Federal Income Tax, to find out whether you need to have tax withheld.

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