

Strategies for Estimated Tax Payments

If your income unexpectedly spiked last year, you may need to make estimated quarterly tax payments this year. These strategies can help you mitigate your tax bite.

An unusual spike in income typically brings not just excitement over the windfall, but uncertainty over the tax implications. Many investors who had unexpectedly sizable gains in 2021 are dealing with this situation now, even though it seems unlikely to repeat in 2022. While taxes shouldn't turn an otherwise positive experience into something negative, it's important to be aware of what the cost will be and, just as importantly, when the taxes have to be paid.

The good news is, these taxes can generally be paid much later than expected. The best way to manage a spike in tax liability is oftentimes to pay as little of the tax during the year as needed to avoid a penalty, with the balance paid when the tax return is filed. If you used that strategy during the boom year of 2021, here are some things you should keep in mind for the 2022 tax year:

EVALUATE IRS TAX PAYMENT REQUIREMENTS AND INTEREST FEES

If you have excess income that's not subject to normal withholding, you'll likely need to make estimated quarterly tax payments throughout the year in order to avoid an underpayment penalty. Payments are due after the end of each "quarter" with payment deadlines usually on April 15, June 15, September 15 and January 15 of the following year.

There are two targets you can aim for in order to avoid a penalty, and you can use whichever one allows you to pay the least during the year:

1. Pay 90% of the current year liability
2. Pay 100% of the prior year liability. If your Adjusted Gross Income for the prior year was more than \$150,000, this increases to 110%. ►

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Let's say you had a tax liability of \$20,000 last year, but expect to have a total tax liability of \$25,000 this year. Over the course of this year, you'll have to pay the lesser of 100% of the prior year tax (which is \$20,000), or 90% of the current year tax (which is \$22,500). For most W-2 or retirement income, ordinary withholding will usually cover most of that – but if it doesn't, or if you have income that isn't subject to withholding, you may have to make additional payments to avoid an underpayment penalty. The balance of that \$25,000 liability would be due when you file your tax return in April.

As long as you hit one of these two targets, the IRS is not likely to assess an underpayment penalty, regardless of how much you pay on tax day. Miss both targets, however, and the IRS will charge interest on the underpayment amount. The interest rate charged on underpayment is currently at 3%. This is an annual interest rate, but the penalty is calculated based on the number days of underpayment, so every day you wait to pay could cost you.

STRATEGIZE YOUR QUARTERLY PAYMENTS

Basing your current year tax payments on the prior year tax liability, known as the "safe harbor" method, gives you a specific target to hit. It doesn't matter how much you ultimately owe when you file your tax return – as long as the payments during the year exceed the safe harbor amount, there will be no penalty.

On the other hand, targeting 90% of the current year liability could give you a lower payment amount now. This method requires carefully estimating your eventual tax cost, so it might make sense to shoot a bit higher, aiming for 93-95% in order to provide some cushion for unexpected events – and avoiding underpayment penalties.

ADD UP ALL YOUR TAXES

The payment calculation is more complicated than it might initially seem, because it includes more than just your basic income tax. You'll also need to account for things like Alternative Minimum Tax, self-employment tax, net investment income tax, etc. On the other hand, you can use various tax credits – such as the foreign tax credit, child tax credit and the child and dependent care credit – to reduce the targeted amount.

Whichever method you choose, it's important to get out in front of your tax strategy for the year. Reach out to your Baird Financial Advisor team to help mitigate your tax bite. While Baird does not offer tax or legal advice, our advisors regularly work with attorneys and tax professionals to help ensure that all phases of your financial plan are addressed.

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