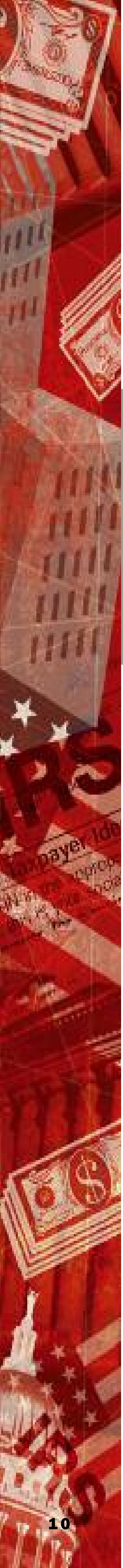
By Valrie Chambers, CPA, and Anthony P. Curatola

Estimated Tax Payments & Small Business Owners



Making quarterly estimated tax payments can lead to cash flow disruptions or nonpayment of taxes for self-employed business owners. Research shows these taxpayers would be more likely to pay on a monthly basis, but someone needs to tell them this option is available.

The federal and state income tax systems in the United States are pay-as-you-go systems. Compliance is accomplished through either withholdings or estimated tax payments. Employees comply, in part, with the system by having their employers withhold taxes from their pay and then remit it to the proper tax authorities (federal, state, and local). Self-employed individuals, on the other hand, comply by paying estimated taxes on a "quarterly" basis.

The IRS last estimated the underreporting and underpayment compliance of taxpayers (also known as the "tax gap") for 2006. The gap was $385 billion, with a net compliance rate of 85.5% (see IR-2012-4, January 6, 2012). In addition, the net tax gap for small business and self-employed taxpayers is estimated to be about 68% of the total tax gap (IRS, "Reducing the Federal Tax Gap," August 2, 2007). Thus, the self-employed are seen as less compliant in reporting and paying their estimated taxes compared to the wage-earning population.

Rules for Filing Estimated Taxes

In general, estimated tax payments are necessary for taxpayers with income that isn't subject to withholdings, such as income from interest, dividend, alimony, and gains from the sale of assets. Taxpayers with income from these and other nonwithholding sources need to either adjust their W-4 withholdings with their employer or make estimated tax payments to each of the appropriate taxing authorities.

Self-employed business owners, however, don't draw wages from their company and, thus, aren't subject to the withholding rules. Instead, they are required to pay estimated federal and state income taxes on a quarterly basis unless they or their spouse have withholdings from income on other sources that are sufficient to cover the additional tax liability from self-employment. Beginning in 2012, self-employed taxpayers must pay self-employment tax and possibly additional Medicare taxes in addition to federal income tax withholdings (see the October 2012 Taxes column, "Affordable Care Act and 2012 Tax Provisions").

The general rule for requiring a taxpayer to remit estimated taxes is when the taxpayer satisfies both of two rules. The first rule is satisfied if the taxpayer is expected to owe at least $1,000 in the forthcoming tax year after subtracting any withholdings and refundable credits. The second rule is satisfied if the taxpayer's withholding and refundable credits for the forthcoming year are expected to be less than 90% of the tax to be shown on the forthcoming tax year's return or 100% of the tax shown on the current tax year's return. These rules are tests of both the absolute and relative dollar amounts.

A special rule applies to high-income taxpayers, which are defined as individuals with an adjusted gross income (AGI) on the current tax year's return that exceeds $150,000, or $75,000 if married filing separately. (No distinction is made here between the married, head of household or single taxpayer.) For high-income taxpayers, the 100% threshold in rule two is increased to 110% of the tax shown on the current tax year's return.

A second special rule applies to farmers and fishermen. Under this rule, the 90% of this year's tax liability figure that appears in the second rule is reduced to 66.67%. A taxpayer qualifies under this category if at least two-thirds of his or her gross income for the current or prior tax year comes from farming or fishing.

Pursuant to IRC §6654, the required (nondelinquent) quarterly payments for those required to make estimated payments are due by April 15, June 15, September 15, and January 15. The payments aren't spaced out exactly on a quarterly basis, but the payment amounts are generally 25% of the required annual payment. As most can appreciate, the April payment coincides with the filing of one's tax return; the April and June payments are only two months apart. Thus, the self-employed taxpayer faces a high demand for cash in a relatively short time span. This situation can easily result in a cash flow problem for most small business owners. Additionally, the final estimated tax payment is due just as holiday bills arrive.

Some researchers have shown that cash flow problems can cause noncompliance, which can lead to underwithholding and underpayment penalties under IRC §6654 and §6655. A review of the IRS Statistics of Income (SOI) showed that the dollar value of this problem has more than doubled in size from $838 million in 2002 to $1.872 billion in 2007, and the number of delinquent taxpayers has increased by nearly 50% (5.1 million in 2002 vs. 7.5 million in 2007). According to the 2007 SOI, taxpayers with an AGI between $100,000 and $200,000 had the greatest number of underpayment penalties (1.6 million taxpayers), while taxpayers in the $200,000 to $500,000 AGI range had the greatest dollar amount of penalties ($443.3 million). The trend for these two AGI ranges has been consistent since 2002, and the gap has increased over the same period.

Alternative Strategies

Cash flow is a major problem for small business owners under normal conditions. When you require quarterly estimated tax payments at the most inopportune time and then penalize the taxpayer for failing to adequately make timely payments, it's no surprise that self-employed business owners incur the majority of the penalties. What can be done? Short of reducing taxes, which isn't likely, proposals include some form of mandatory reporting or an increase in the enforcement of collecting the tax. But the imposition of additional penalties on a population that is stressed already about paying its debts, including tax payments, likely won't solve the problem—and most politicians wouldn't want to be associated with such an unfavorable provision toward taxpayers. So what other options are possible?

Most bills are paid monthly, so why not taxes? We conducted a study of alternative payment schemes for making estimated tax payments. Specifically, we gave taxpayers the explicit option to make smaller, monthly estimated tax payments instead of larger, quarterly estimated tax payments. This option exists now, but it isn't stated explicitly in (or prohibited by) the Code, Form 1040-ES, or its instructions. Taxpayers are free to adopt this method without permission or to abandon it after its adoption.

The study provided some interesting results. We found that self-employed taxpayers were more likely to pay their estimated taxes on a monthly basis if that option were clearly and explicitly presented to them. Moreover, the delinquency penalty of this group was significantly less than those making quarterly payments. Taxpayers with the option to pay monthly often did so, were less likely to get behind in paying their estimated tax liability, and, if they did get behind, weren't as far behind as those respondents who weren't told of the monthly option to pay taxes. Tax advisors with clients who have trouble making quarterly estimated tax payments may want to advise clients to make smaller, more manageable monthly payments in order to avoid underpayment penalties and end-of-year delinquencies.

At first blush, these results seem counterintuitive. One would expect the average person to delay paying taxes as long as possible. But if we look at the situation a bit closer, we begin to recognize that the average business owner looks for stability and the maintenance of a consistent cash flow. Owners typically match the payment of bills with revenue, which usually comes in more than once a quarter. The federal and state estimated tax payments actually disrupt the steady cash flow by requiring quarterly payments.

This situation of underpayment

continued on page 69

Taxes

continued from page 12

has the potential to become even worse in the coming year. If we assume that Congress will fail to extend the soon-to-vanish Bush-era tax provisions, then business owners are likely to see a tax increase and, consequently, an increase in the estimated tax payments. In addition, the estimated tax payments will increase even further as a result of the Health Care and Education Reconciliation Act of 2010. Thus, these taxpayers will be facing a tough economy while facing significantly increasing tax liabilities.

Although tax advisors can reduce the tax liability only so far, they have the opportunity to assist their clients by alerting them to a little known option to prepay taxes at a faster rate. This scheme has the dual benefit of reducing the business stress of cash flow for the owner and the potential loss of cash flow through the need to pay an underpayment tax penalty. Explained in ordinary terms: How do you eat an elephant? One bite at a time. **SF**

Valrie Chambers, CPA, Ph.D., is a professor of accounting at Texas A&M University-Corpus Christi. She can be contacted at (361) 825-6012 or valrie.chambers@tamucc.edu.

Anthony P. Curatola is the Joseph F. Ford Professor of Accounting at Drexel University in Philadelphia, Pa., and a member of IMA's Greater Philadelphia Chapter. You can reach Tony at (215) 895-1453 or curatola@drexel.edu.