

TAX TALK
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HOW DO I ADJUST MY WITHHOLDINGS TO THE PROPER AMOUNT?

Another tax season has passed and one of the most common questions that I have had to address in the past 3 months is “How do I calculate my withholdings so that I pay in the appropriate amount of taxes?”

Calculating Your Taxes

The first concern when calculating your withholdings is projecting the amount of income and deductions that you think you will have in the coming year (2011). Most of us are familiar with Form W-4 which is provided by an employer and we mark off single or married and some number of exemptions.

The problem with using form W-4 is that while it tries to take many things in to consideration, such as whether 2 spouses work and what your estimated itemized deductions are, it is a form that is too general in nature. There are many situations that occur within a tax return that are difficult to predict using Form W-4. Some examples of these situations could be education credits or deductions and alternative minimum tax.

In my opinion, the best way to calculate your withholdings is to first input your projected income and expenses on a tax form and calculate as accurately as possible the amount of projected income tax. Once the tax is calculated it is easy enough to find the deduction amount for your salary that provides the answer you need.

An example is provided below:

Let's start with a married couple with 2 children that have gross income of \$125,000 and itemized deductions (income taxes, real estate taxes, mortgage interest and charitable contributions) of \$31,800. This calculation (using 2010 rates) yields an income tax liability of approximately \$12,000.

Once we have the calculation above it is now easy to determine that in order to have a \$0 balance due on April 15, 2012 the taxpayers must withhold \$1,000 per month (if paid monthly) or \$461.54 per paycheck (if paid biweekly) or \$230.77 per paycheck (if paid weekly). Looking at the appropriate charts to find the correct withholding allowance (married 4 vs. single 3, etc). is now a very simple task.

What About Estimated Tax Payments?

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In some situations, using only withholdings may not work. Some typical situations that would cause problems would be if the taxpayer(s) have significant untaxed income (interest, dividends, self employment income or income from partnerships or S corporations). In these situations you would still calculate your taxes as above, however in addition to withholding on paychecks the taxpayer(s) may have to also make quarterly estimated tax payments to the government.

Conclusion

This article discusses how to determine your tax payments. While I focused on federal income taxes, the same theories would hold true for state income taxation. I would encourage anyone who is attempting to use these methods to contact a tax professional who can help you through the process.