Breaking Down a Tax Return

What Every Advisor Should Know

By Debra Taylor CPA/PFS, JD, CDFA

Taylor Financial Group, LLC

horsesmouth®

Breaking Down a Tax Return:
What Every Advisor Should Know

Edition 1.0

For information contact:

Horsesmouth, LLC.
888.336.6884 (Outside the U.S.: 212.343.8760)
reports@horsesmouth.com
21 West 38th Street
New York, NY 10018

Breaking Down a Tax Return: What Every Advisor Should Know

By Debra Taylor, CPA/PFS, JD, CDFA

Reviewing clients' tax returns is a great way to provide a service that is hard to come by. Moreover, you gain access to information that can help clients make better financial decisions and lead to more business. With the advent of tax review software, in our case Holistiplan, this task is much easier than before since the software does most of the tedious work for you. However, it doesn't do everything! We integrate the information and capabilities of the software with our own checklists and work to bring clients a comprehensive service experience.

The Holistiplan software provides a basic report showing a variety of thresholds and ranges and where your client places. It is a great starting point to help identify opportunities and trouble zones, such as Medicare IRMAA surcharges, qualifying for a variety of tax credits, and other tax breaks. The software-generated report saves us a lot of labor and is very client friendly, but it is still only a beginning point for the tax return review.

Area 1: Review changes in personal life

Even in the first section, you can immediately add value and look for additional opportunities.

Address: Has your client recently moved? Ask your client if she has adequate home insurance coverage. Did your client have capital gains on the sale and how does she want to invest those proceeds? Will she be saving money on state taxes?

Filing status: Is your client recently divorced or widowed? Such a change could have cash flow and tax consequences. Be sure to suggest a meeting with your client to start a financial plan.

Age: Is your client age 72 and required to take distributions from her IRA? Add value by letting your client know the required minimum distributions (RMDs) that must come out of an IRA and/or retirement plan. Does your client want to invest her RMD with you? Should you consider a Roth conversion? Or does she want to donate her RMD to charity? If so, she should strongly consider a qualified charitable distribution (QCD). This is a tax-free distribution made directly from an IRA to an eligible charity when the client is 70½ or over, and it will save her taxes.

Did your client turn 62 or 65? If so, discuss the timing of Social Security benefits and Medicare.

Dependents: Does your client have enough life insurance to cover her family and is the policy suitable for their situation? Is she overpaying for whole life where a term or a universal life policy would do just fine

Has your client considered opening a Section 529 account to take advantage of tax-free growth and possible state tax deductions? Due to the new Tax Act that was passed in 2017, your client could even use up to $10,000 to pay for K-12 education.

Area 2: Income source

Wages and salaries: Look at ways for your client to reduce taxable income. Is she contributing to her employer-sponsored retirement plan and is she contributing enough to receive the match? Show your client the chart below so they can visualize the potential for contributions.

Qualified Savings Contributions Available	Maximum (2020)
401(k) Contributions	$ 19,500
401(k) Catch Up Contributions (starts age 50)	$ 6,500
401(k) After-Tax Contributions	$ 37,500
IRA Contributions	$ 6,000
IRA Catch Up Contributions (starts age 50)	$ 1,000
HSA Contributions (couple or family)	$ 7,100
HSA Catch Up Contributions (starts age 55)	$ 1,000
Total Potential Contributions (over age 55):	**$ 78,600**

Does your client have stock options with her employer? Discuss a strategy for exercising the options so your client is aware of future taxes.

Is your client in the highest marginal income tax bracket? You could make a compelling case for your client to invest in municipal bonds that produce federal tax-free gains and potentially tax-free state and local gains.

Did your clients change jobs in the last year? Ask about potential 401(k) rollovers.

Interest and dividends: Are the dividends and interest from the investments held with your firm? If the client has outside accounts, she may want to consolidate accounts for simplicity and possibly to save on investment management fees.

Does the client have interest from many CDs or bank accounts? This might also be a good time to review the investment strategy and current allocations.

Alimony: Has your client recently divorced? Inquire if the assets are in the process of being divided. If your client is under the age of 59½ and requires money, suggest taking cash from a retirement plan that is being split to avoid the 10% early withdrawal penalty. Once she rolls her portion of the assets into an IRA, she will lose this exception.

Review the beneficiary designations as well as any estate planning documents to make sure they are current after the divorce.

Also, will your client keep the child tax credit (worth $2,000 for each child) for any dependents or will that credit be kept with the former spouse?

Suggest an overall review of the budget because of the divorce, and remember that divorces after 2018 do not allow for the deductibility of alimony and therefore the division of assets will need to be viewed differently. Perhaps consider transferring low basis items or the traditional IRA to the lower income spouse now that alimony is not a tax preferenced item.

Business income: Did you discuss qualifying for the QBI deduction, which is worth up to 20%? Does your client own a small business and not have a retirement plan established? Explore the possibility of setting up a SEP IRA, SIMPLE IRA, or 401(k) plan that can offer tax deductible contributions, tax deferred growth, and can be a valuable employee retention tool.

And don't forget the profit-sharing plan, where your client could contribute up to $225,000 in one year, and obtain a tax deferral.

Capital gains: Also discuss the donation of highly appreciated stock that has been held for at least one year so that your client can avoid capital gains (which she would have to pay if she sold the stock herself, and then donated the proceeds to charity).

If the client has capital gains, discuss harvesting losses in the future. Does the client know how to handle loss carryforwards? This may be an opportunity to have a conversation about diversifying the portfolio.

IRA distributions: Does the client have a strategy for the additional income that will be realized as a result of taking the RMD? Does the client have enough taxes withheld for each distribution? Make your client aware that there could be an underpayment penalty if not enough taxes are withheld upfront. And again, remind her of the QCD tax savings opportunity of over age 70½.

Also, discuss the possibility of converting a traditional IRA to a Roth IRA if the client is prepared to pay the taxes. The heirs could benefit from tax-free distributions and it would cut down on the RMD (and the resulting taxes). Discuss distribution optimization planning, which is becoming critical for all retirees.

Health Savings Account (HSA) deduction: Ask your client if she has a high deductible health insurance policy, because she could contribute $7,100 to an HSA (or $3,550 if an individual) that would allow her to withdraw the funds tax-free in retirement for medical expenses. A big win all the way around, since medical expenses are on their way up.

Area 3: Itemized deductions on Schedule A

Some accountants may not look too closely at your clients' situation to find additional deductions. This is an opportunity to look at the following items.

Medical expenses: Introduce the possibility of bunching medical expenses into one tax year where your client could take the standard deduction one year and then itemize in the next year. This strategy allows the client to take advantage of higher itemized deductions in alternate years.

Remind your client of the 7.5% of AGI floor before medical expenses can be deducted.

Interest expenses: Does your client have a home equity loan? Schedule a discussion about the benefits of accessing low-interest cash in case of an emergency. Indeed, we like all clients to have access to a line of credit "just in case." In addition, review the interest rates being paid. If the current average interest rate on a home equity line is 4.2%, but the client's portfolio is returning 6.5%, then the home equity line still can make sense.

Charitable contributions: If your client makes charitable contributions, they will be made in either cash or through some other form, such as appreciated securities. Discuss the qualified charitable distribution or the opportunity to bunch payments to maximize their deductions.

Has your client also considered establishing a donor-advised fund (DAF)? This fund allows an individual to make contributions to a public charity and receive an immediate tax benefit (but she can distribute funds to the charity over time). If your client establishes a DAF, she can take one large upfront deduction and then possibly itemize that year on her tax return.

It all comes down to knowing your client and making a difference

Many clients have complained that their previous advisors have never asked for their tax returns. And as I have said several times, we are winning business from other advisors based on tax discussions alone in our approach talks. And, you will make a difference in their lives.

If your client has either a substantial return or underpaid taxes, you may want to make a referral to a tax advisor to adjust the withholding. Does your client have a large refund? Discuss possible investment strategies for those funds.

In addition to the tax return, we request that each client obtain a tax projection from their tax professional every year so that we can perform tax planning. With so many changes and so many opportunities to save money on taxes, we find the information to be invaluable. It allows us to verify information provided to us regarding client spending and income, as often clients have no idea what they are making or spending! We then take this information and update their financial plans, which clients appreciate. All in all, there are a multitude of ways to add value and increase wallet share, so that all advisors should consider including a tax return review as part of their annual service offering to all clients.

The American Institute of CPAs has an amazing resource called "Analysis of a Tax Return for Financial Planning Opportunities" here:
https://www.aicpa.org/content/dam/aicpa/interestareas/personalfinancialplanning/resources/taxplanning/downloadabledocuments/analysis-of-a-tax-return-for-pfp.pdf