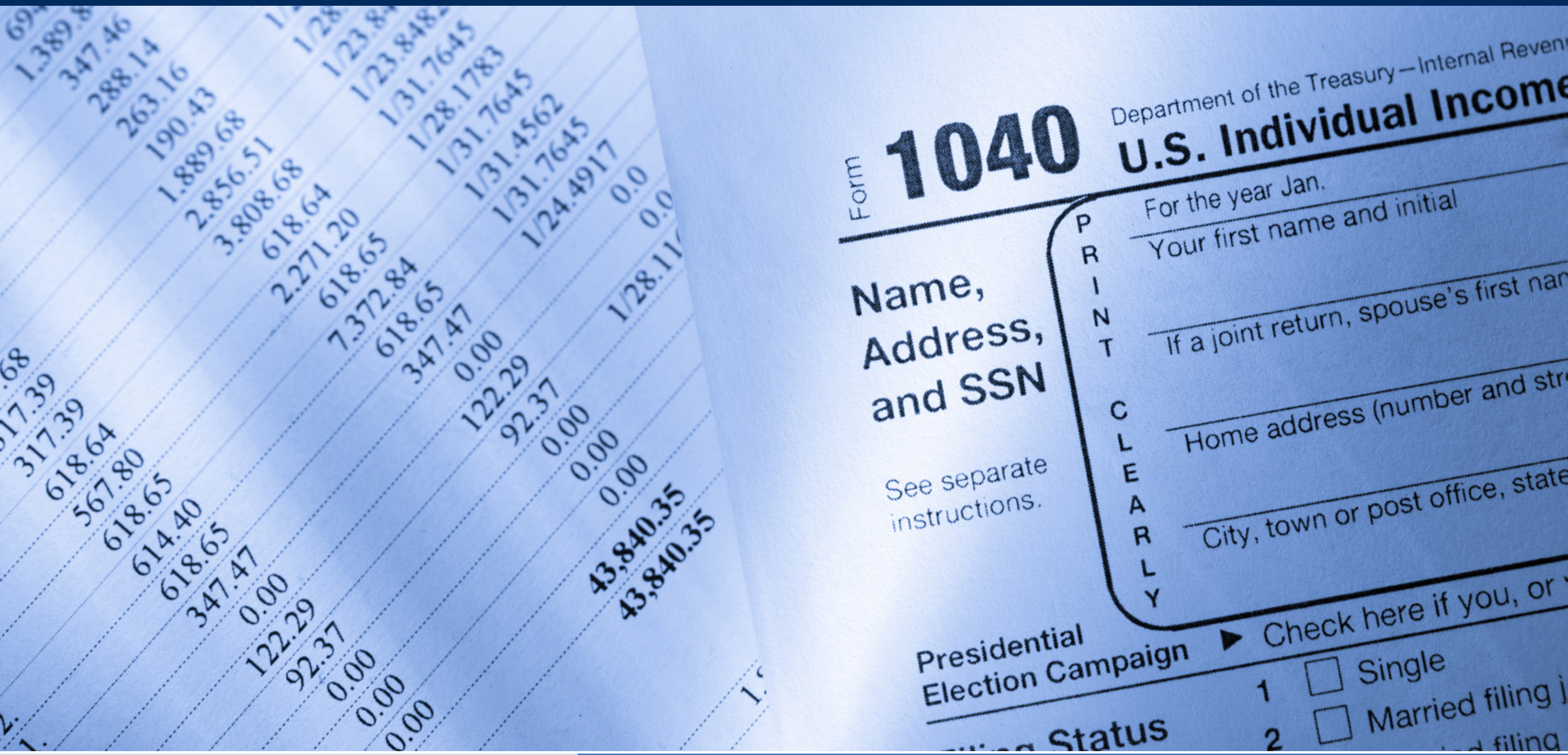

The Financial Advisor's Guide to Reviewing Client Tax Returns for Planning Opportunities

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Reviewing tax returns presents a great opportunity for adding value to the client-advisor relationship. Tax returns provide a tremendous amount of information about a client's or a prospect's financial situation, giving you the chance to identify planning opportunities and, in some cases, opportunities for adding assets under management.

Generally speaking, people fall into two categories: those who are dismayed by higher-than-anticipated tax liabilities and those who are pleasantly surprised by tax refunds. But whatever the situation, most wonder if they can do something different to reduce their tax burden now and in the future. Few clients or prospects will decline an offer to review their tax returns or evaluate their overall financial situation.

When establishing expectations for assessing a tax return, ask your client (or prospect) to mail or e-mail you a copy after he or she files. Then, schedule an annual review and use the tax return as a road map for exploring future strategies for his or her investment or financial plan. Through your careful attention, you'll demonstrate your commitment to offering meaningful guidance and support. And, by and large, you will be the only advisor to invest this kind of time and interest in the client.

What follows is a guide for using the tax return to enhance and expand the client-advisor relationship.

Step 1: Validate the client's understanding of the big picture

Ask questions to determine the client's level of knowledge and sophistication around income tax planning. With a glance at a current return, you can assess earned income, income sources, business activity, tax liability, and marginal tax rates. Compare these with the same items on the prior year's return to quickly determine whether there have been significant changes; if so, use the current return to discuss variations in the client's situation and to explore changes for the year ahead.

As part of your review, be sure to find out who did the return. An accountant? A friend? Did the preparer use TurboTax? Is the client or prospect working with someone who understands income tax? Does he or she understand that your role is to help coordinate tax planning now and in the future, not to prepare the return?

Step 2: Conduct a line-item review of the client's tax return

Personal Information, Filing Status, and Dependents

- **Address.** Did the client recently move? If so, did the client sell his or her previous home, or was it kept as an investment property? Is there adequate insurance coverage for the new residence and the old, if it was kept? In addition to homeowner's insurance, does the client have an umbrella policy?
- **Filing Status (Lines 1–5).** A change in filing status may affect the client's insurance and estate planning needs. If the client is recently divorced, he or she may need to update estate planning documents and review beneficiary designations for life insurance, retirement plans, and annuities. If divorcing spouses are changing their filing status from married filing jointly to single, which party is keeping exemptions for children?
- **Dependents (Line 6).** A life insurance review may be in order if the client has dependents. How does the client plan to provide for the family in the event of his or her death? (If there are no dependents, review the life insurance needs of the client's spouse.) Are the client's estate planning documents up to date, and do they reflect the client's wishes for the family in the event of his or her death? Does the client wish to plan for children's future education costs? Finally, is the family affected by the kiddie tax rules, which apply to unearned income over $2,000 for children under 19 (or full-time students under age 24)?

Income Sources

Managing income has become more important given recent changes to the tax code. The 3.8-percent Medicare tax on investment income introduced in 2013 affects individual taxpayers with modified adjusted gross income (MAGI) over $200,000 ($250,000 for married couples filing jointly). The tax equals 3.8 percent of net investment income or the excess of MAGI over the threshold, whichever is less. An additional 0.9-percent Medicare contribution tax is levied on wages and self-employment income above these thresholds. These are separate taxes and are reported on line 60 of Form 1040.

As you review your client's return, use lines 7–22 on Form 1040 to get a handle on total income and income sources for the current year, as well as to project income for future years.

- **Wages and Salary (Line 7).** Is the client funding employer-sponsored retirement plans? Contributions to such plans can directly reduce adjusted gross income (AGI), and the client may also benefit from employer matches for contributions. For nonqualified stock options, exercise strategies can help the client plan for the recognition of income in certain tax years. (Be aware of alternative minimum tax concerns when the client exercises incentive stock options.)

  To reduce taxable income, the client may want to consider charitable giving strategies, such as donor-advised funds or charitable trusts. (Commonwealth has strategic relationships with charitable administrators for clients who wish to pursue these options.) Is the client planning for a child's education? 529 college savings plans may help the family avoid taxes on future growth when distributions are used for qualified higher education expenses.

Income Sources *continued*

- **Interest and Dividends (Lines 8–9).** Is the client happy with his or her current investment choices? Is there a need for diversification? Given the current tax environment, is there a need for tax-deferred or lower-tax investments?
- **Alimony (Lines 11 and 31).** If the client has experienced a significant financial change in the prior year, such as divorce, you may need to conduct a particularly thorough review. For instance, one spouse may have just begun to receive alimony, so this year's return may only reflect two or three payments, whereas next year's will include a full year. Is the client aware that the receipt of alimony is taxable and that it should be part of his or her overall tax planning? Clients paying alimony may want help creating a new budget. Spousal support obligations are another good reason to double-check the client's life insurance coverage.
- **Self-Employment Earnings (Lines 12 and 17).** If the client's business is unincorporated, discuss the potential benefits of incorporation or forming an LLC. Also review whether the business is properly insured and whether the client would like to provide employees with insurance coverage (e.g., worker's compensation, disability). Retirement savings plans—such as SIMPLE IRAs, SEP IRAs, profit-sharing plans, 401(k)s, and defined benefit plans—can be an important addition to a business, offering tax-deductible contributions along with tax-deferred growth.
- **Capital Gains (Line 13).** The top capital gains rate is now 20 percent at the top marginal tax bracket, 39.6 percent. Given that the 3.8-percent Medicare tax also impacts capital gains, reviewing the client's capital gains and losses may reveal important tax planning opportunities. Could the client harvest losses to offset capital gains? Does the client need a strategy for loss carryforwards? If the client has concentrated stock positions, diversifying the portfolio may involve spreading the sale out over time.
- **IRA and Pension Distributions (Lines 15–16).** If the client is taking distributions from an IRA, is it the normal required minimum distribution (RMD)? If it is more, does the client need the additional income? If not, he or she might consider using the RMDs to purchase insurance as an income tax-free asset for heirs. Also assess whether the client is in a position to consider converting an IRA to a Roth IRA. If the client can manage the accelerated income taxes, it may allow his or her beneficiaries to enjoy income tax-free distributions.
- **Rental Real Estate, Royalties, Partnerships, S Corporations, and Trusts (Line 17 and Schedule E).** A review of Schedule E, which feeds into line 17, may reveal pass-through tax liability from activities such as a trust, partnership interest, S corporation, LLC, or rental real estate. Does the client understand the tax consequences of rental real estate? Many people may overestimate the current tax benefits. It's important to recognize that most losses are considered passive, and, if the client's income exceeds threshold limits, these losses cannot be taken on the client's tax return until the property is sold. Are the property investments reasonable for the client's portfolio?
- **IRA Deduction (Line 32).** Is the client eligible for an IRA deduction, and if so, is he or she taking advantage of it? If the client already has an IRA, is he or she happy with the investment allocations and beneficiary designations? Would a Roth conversion benefit the client? These discussions may lead to the discovery of IRA assets rolled over from a previous qualified plan.
- **Overpayments or Underpayments (Lines 72–73).** Review the client's withholding or estimated payment schedule to make the necessary adjustments.

Itemized Deductions (Schedule A)

Itemized deductions, listed on Schedule A of Form 1040, are phased out for higher-income taxpayers. The AGI threshold is $250,000 for single filers ($300,000 for married couples filing jointly). Allowable itemized deductions will be reduced by 3 percent of the amount by which the taxpayer's AGI exceeds the threshold amount. The reduction cannot exceed 80 percent of previously allowable itemized deductions.

- **Medical and Dental Expenses (Lines 1–4).** Medical expense deductions have a floor of 10 percent of AGI. The client should be careful to track expenses and be aware of all expenditures. Bundling expenditures into one tax year can be beneficial.
- **Real Estate Taxes (Line 6).** Higher real estate taxes may indicate a high-end primary residence or ownership of multiple properties. Does the client have a second home? Is there a need to plan for liquidity? Property held in multiple states may require additional attention from an estate planning perspective to reduce taxes and avoid probate.
- **Interest Expenses (Lines 10–14).** High interest deductions may indicate an opportunity for the client to refinance. Does the client have a home equity line? If so, it may be a good time to conduct a budget review. Points paid are indicative of a new real estate purchase. Is there a need to examine life insurance to help cover the debt in the event of an unexpected death?
- **Investment Expenses (Line 23).** Review whether the client can deduct investment advisory fees as "ordinary and necessary expenses" paid for producing taxable investment income. Such expenses include payments for investment advisory services (counsel and advice), attorney or accounting fees, custodial fees, tax advice and preparation fees, and rental of a safe deposit box used to store taxable securities or investment-related papers and documents.
- **Charitable Contributions (Lines 16–17).** Could the client benefit from a charitable deduction? Charitable planning can take many forms, such as outright gifts, establishing a donor-advised fund, or the use of charitable trusts. If the client has appreciated stock, it can be donated to avoid capital gains while achieving the client's charitable planning goals.

Step 3: Look at investment activity

A review of investment income is essential when evaluating a client's financial position. Examine the brokerage and fee-based accounts (not what was owned in those accounts) that reported interest and gains for the prior year. Review Schedule B (Interest and Dividends) and Schedule D (Capital Gains and Losses), too. The following items should trigger further discussion:

- Large amounts of interest from banks may reveal large CDs. Make a note of the maturity dates for future discussion of alternatives.
- Interest received from numerous institutions may lead to a discussion of the benefits of asset consolidation to achieve effective portfolio management and minimize advisory fees.
- Dividends reported from individual stocks may indicate certificates held in a safe deposit box. Use this as an opportunity to discuss portfolio consolidation.
- Large losses on individual stocks or numerous trades resulting in gains and losses on a Schedule D could easily prompt a discussion of whether there is a definable investment policy or strategy in place for assets outside your firm.
- Carryover losses from Schedule D (line 21) can present a great opportunity to rebalance or restructure portfolio assets, including moving assets to your investment management platform.

Step 4: Don't assume static income

Unfortunately, many investors and tax software packages automatically assume that income will remain static from year to year. If this assumption is made when calculating future estimated tax payments, a client could be in for a surprise down the road. Estimates may be too high and a refund could be in order—perhaps exciting, but not efficient planning. On the flip side, estimates may be far too low and an unexpected tax bill could come due.

If you suspect that income estimates for the coming year may be off, suggest that your client contact his or her accountant or rerun software projections using revised income projections. If estimates cover the safe harbor amount, there's no reason to pay more; however, clients do like to know well in advance if they are projected to owe money. This may also prompt the client to talk about upcoming changes in his or her job, business activities, pensions, and so forth.

It's also important to review investment income, particularly if the client has investments managed outside your firm. If there was nonrecurring investment activity, such as large realized capital gains or unusually large reported losses, estimates of the coming year's tax liability may be off considerably. You may have to be concerned with the wash sale rule if portfolios are similarly managed.

Step 5: Plan for age-related milestones

Don't overlook the obvious planning opportunities. Have a discussion about social security strategies and Medicare enrollment timing. Be especially vigilant with widowed or divorced clients, as they may be eligible for benefits based on another's age or retirement status. Often, clients who will begin to receive retirement distributions in the coming year haven't planned for them when projecting current-year tax liability. To maximize income sources, it's wise to have these conversations years before clients retire.

Step 6: Build a retirement income portfolio

As the client moves toward retirement, review the existing portfolio and consider whether it requires a complete repositioning of assets. Many investors make the mistake of reallocating their investments at retirement, subjecting themselves to a higher tax bracket for that year and underestimating the amount of the tax bill. Discuss this with the client long before retirement, and consider repositioning assets within qualified and nonqualified portfolios to minimize taxable gains. Plan for how and when you will reposition the portfolio, or create a distribution policy statement to help coordinate future funding of income requirements.

Step 7: Keep track of key information

To ensure that you have the client's important tax information on hand throughout the year, make a few notes to create a "tax snapshot" for your records. Note the amount and type of income expected (W-2, 1099, investment, IRA distributions, and so on), the marginal tax rates expected, available carryover losses, projected tax liabilities, and any unusual activity. This will help you stay in step as your client's financial picture evolves.

A Worthy Investment

Dozens of planning opportunities may come up when reviewing a client's tax return, including increasing 401(k) contributions, tax-advantaged investing, tax-deferral options, charitable strategies, insurance sales, and estate tax returns. Plus, it's an excellent way to deepen your relationship with the client. At the very least, a review will inform you of the client's income and tax situation and alert you to any need to consult with his or her tax professional. Gauging a client's tax situation is essential for providing the best possible investment planning advice.

Although you can glean a lot of valuable information from reviewing a tax return and discussing it with the client, the process doesn't have to take a long time. Simply examine the return in advance and then guide the client through a discussion of the important issues.

Please keep in mind that you cannot give tax advice or help clients prepare their tax returns.

What to Look for on Clients' Tax Returns

What to Look For	Planning Opportunity
Personal Information	
Client Age	• Ages 62, 65, and 70½ trigger retirement, social security, and Medicare events. Discuss when the client plans to retire and the need for asset allocation and income planning before retirement.
Address	• Did the client recently move? If so, did the client sell the previous home? • Is there adequate insurance coverage for the new residence and the old, if it was kept? Does the client have an umbrella policy?
Tax Preparer's Information	• Find out who prepared the return. If a CPA, consider setting up an annual tax planning meeting.
Filing Status (Lines 1–5)	• A recent divorce will have tax and cash flow implications. Discuss the benefit of a financial plan. • Does the client have estate or life insurance planning needs?
Dependents (Line 6)	• A life insurance review may be in order to provide family benefits in the event of death. • Is the family affected by the kiddie tax rules? • Consider a tax-advantaged 529 plan.
Income Source	
Wages and Salary (Line 7)	• Is the client funding employer-sponsored retirement plans? • Could the client benefit from a stock option strategy review? • Consider charitable giving strategies.
Interest and Dividends (Lines 8–9)	• Review investment allocation and strategy. • Is the portfolio being managed in a tax-efficient manner? • Are there accounts with other advisors? Consolidating accounts can minimize fees. • Were losses carried over from a prior tax year? Was there churning in the account? • Does the client have an investment strategy? • Is there overreliance on tax-free bonds? • Is there overreliance on CDs? How is the client managing the FDIC limits? What are the CD maturity dates? • Stock dividends could indicate securities held in a safe deposit box. Are these incorporated in the overall investment plan?

What to Look For	Planning Opportunity
Income Source *continued*	
Alimony (Lines 11 and 31)	• Review budget changes from payment or receipt of alimony. • Does the client have sufficient life insurance coverage to replace spousal support obligations?
Self-Employment (Lines 12 and 17)	• Review business entity and discuss benefits of incorporation or forming LLC or partnership. • Is adequate business insurance in place (disability, worker's compensation)? • Consider implementing a retirement plan.
Capital Gains (Line 13)	• Review strategies to manage Medicare tax. • Is there an opportunity to harvest losses to offset capital gains? Does the client need a strategy for loss carryforwards? • Does the client have concentrated stock positions? Diversifying the portfolio may involve spreading the sale out over time.
IRA and Pension Distributions (Lines 15–16)	• Is the client taking normal RMD distributions? If it is more, does the client need the additional income? Consider using unnecessary RMDs to purchase insurance. • Consider a Roth conversion.
Rental Real Estate, Royalties, Partnerships, S Corporations, and Trusts (Line 17 and Schedule E)	• Is a pension distribution listed in 17a? Is there a corresponding entry in 17b? If not, qualified money was rolled into an IRA. • A review of Schedule E may reveal pass-through tax liability.
IRA Deduction (Line 32)	• Is the client taking advantage of tax-deductible contributions to an IRA?
Medicare Tax (Line 60)	• Review strategies to minimize taxable investment income.
Overpayments or Underpayments (Lines 72–73)	• A refund should trigger an adjustment in withholding. • A tax penalty may indicate that estimated payments or additional tax planning are needed.

What to Look For	Planning Opportunity
Itemized Deductions (Schedule A)	
Medical and Dental Expenses (Lines 1–4)	• Bundling expenditures into one tax year can be beneficial. • High expenses could indicate a special needs child or elderly parent. Review client's life and long-term care insurance.
Real Estate Taxes (Line 6)	• Does the client own multiple properties? • Multiple-state ownership could indicate a need for estate planning.
Interest Expenses (Lines 10–14)	• High interest deductions may indicate an opportunity to refinance. • Points paid are indicative of a new real estate purchase. Is there a need to examine life insurance to help cover the debt in the event of an unexpected death?
Investment Expenses (Line 23)	• Look for investment advisory fees paid to another advisor.
Charitable Contributions (Lines 16–17)	• How does the client make charitable contributions? Consider donor-advised funds, charitable trusts, or private foundations. • If the client has appreciated stock, it can be donated to avoid capital gains while achieving charitable planning goals.

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