7 Questions to Ask Your CPA Before Year-End

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WEALTHGUARD

–Debra Taylor, CPA/PFS, Esq., CDFA

Given the complex tax situation many high-income earners face, start tax planning in the fall while there is still time to make adjustments. These seven questions can help you spot problem areas and better understand the services you may need.

Although tax season is still months away, tax management should begin in the fall – especially for high-income earners facing the 3.8% net investment income tax, AMT, and other taxes.

Below are seven questions that can help you open a discussion with your CPA and your financial advisor about next year's tax bill. Have the discussion early in the fall so you still have time to make adjustments if necessary.

1. Can I limit my exposure to the 3.8% Medicare surcharge tax?

The 3.8% Medicare surcharge applies to net investment income of singles with modified adjusted gross income (MAGI) over $200,000 and couples over $250,000. The threshold for separate filers is $125,000. (MAGI is adjusted gross income (AGI) plus some deductions added back in for tax-free foreign income, IRA contributions, student loan interest, etc.) The tax is due on the smaller of net investment income (interest, dividends, annuities, gains, passive income, and royalties) or the excess of MAGI over the thresholds.

If you think there may be some exposure, review with your advisors the tax efficiency of the portfolio holdings, perhaps moving less efficient investments into tax-deferred accounts, and capitalizing on tax loss harvesting.

Other ideas include using municipal bonds to help avoid the surtax, since interest is tax-free, and/or taking capital losses to offset any other gains you may have. You may also want to consider an installment sale to spread out a large gain if that keeps your AGI below the thresholds. If real estate is involved, a like-kind exchange will also defer the gain.

2. Can I maximize the tax break using a Flex Plan for child care costs?

You can still claim the dependent care credit to the extent that your expenses are greater than the amount you pay through your flexible spending account (FSA).

The maximum dependent care costs funded through an FSA are $5,000, but the credit applies to as much as $6,000 of eligible expenses for filers with two or more children under age 13. In that case, you should run the first $5,000 of dependent care cost through the FSA, and the next $1,000 would be eligible for the credit on Form 2441.

For most filers, taking the dependent care credit will save an extra $200 in taxes. Of course, no credit is allowed for any child care costs that are paid via the flex plan.

3. What if my school-age child went to summer camp?

Costs related to a child's summer camp qualify for the dependent care credit. So if a you sent your child to any special day camps this summer (i.e., sports, computers, math, theatre, reading, and study), don't forget this break.

However, the costs of summer school and tutoring programs aren't eligible for the credit. They are treated as education, not care. The other rules for the credit aren't affected: the child must be under 13 and expenses must be incurred so that the parents can work.

4. How should I handle an inherited IRA?

If you inherited an IRA last year, a tax planning deadline is looming. The IRA's beneficiaries are set for September 30th of the year following the death of the IRA owner. Typically, the heirs are able to take distributions from inherited IRAs over their lifetimes, unless one or more of the beneficiaries of the account are not individuals.

With non-individual beneficiaries, the IRA has to be cleaned out within five years for all beneficiaries, which is generally a negative because it denies tax-deferred growth to the beneficiaries over their lives, which is a longer period of time. The issue occurs when the owner names a charity or college as one of the beneficiaries.

Redeeming a non-individual IRA interest by September 30th can pay dividends. If the charity, school, etc., is paid off by that time, the remaining individual beneficiaries can take distributions over their lives, enjoying more tax-free buildup inside the IRA.

5. How can I optimize the earnings on my children?

Optimize a child's summer job by contributing to a Roth IRA. The child can contribute up to $5,500 as long as he has earned income of $5,500 or more. The parents can make the contribution for the child, although the parent's pay-in counts towards the $14,000 annual gift tax exclusion.

What difference does this make? A parent's generosity can provide a nice nest egg. A $5,500 contribution to a 16-year-old's Roth that earns 7% each year will grow to $151,000 at age 65 and $212,000 at age 70. If the child works for a couple of summers and contributions are made annually, the future balance of the account will be much more significant. And remember, all qualified withdrawals are tax-free!

6. How can I use the 0% rate on long-term goals?

If your taxable income without long-term gains is in the 10% or 15% tax bracket, profits on the sales of assets owned over a year are tax-free until the gains push you into the 25% tax bracket which starts at $75,901 of taxable income for married couples and $37,951 for singles.

If part of the gain is taxed at 0% and the rest at 15%, claiming more itemizations or making a deductible IRA contribution gives you two tax breaks: 1) claiming the deduction saves on income tax and 2) it allows more capital gains to be taxed at the 0% rate.

However, taking more tax-free gains raises the adjusted gross income, which can cause more of your Social Security benefits to be taxable. In addition, your state income tax bill may jump, since many states tax gains as ordinary income.

7. How can I donate most effectively?

One way to turbo-charge donations to charity is by giving away appreciated assets, such as stocks. The appreciation escapes the capital gains tax and you will get a deduction for the full value in most cases, as long as you've owned the asset for longer than a year.

However, deductions for donations are reduced when adjusted gross income is over $261,500 for singles, $287,650 for the household head, and $313,800 for married couples.

The right assets to donate

Do not donate any assets that have declined in value. If you do, the capital loss is wasted. From a tax point of view, you're better off selling the asset and donating the proceeds. This also applies if you plan to make a gift to a person. If you give an asset that has diminished in value, you are then unable to sell the asset and deduct the loss.

Consider a charitable lead annuity trust

A charitable lead annuity trust is a trust that pays an annuity to a charity for a set term. Then, what's left goes to the donor or other beneficiaries. Although interest rates may increase, the donor still gets a nice up-front write-off. That deduction can be used to offset income generated from a Roth IRA conversion, such as letting the donor experience a full lifetime of tax-free withdrawals from the Roth.

Sustainable non-cash donations

If you fail to substantiate property donations, you can lose the write-off. For example, a veterinarian donated over $100,000 of fossils to a charity, and although he did attach Form 8283 to his tax return and received letters from the charity acknowledging the gifts, the fossils were not appraised properly as they were not seen by a qualified expert, which is mandatory when claiming a deduction over $5,000 for non-cash donations.

The taxpayer also failed to obtain a contemporaneous written acknowledgement from the organization stating that he received nothing of value in return for his gift. As a result, the tax court upheld the IRS determination to disallow the deduction.

Understanding tax laws isn't easy, especially since the laws change constantly and are often tricky. Attempting to take advantage of the benefits can be a confusing process. Though there are some great tips and explanations above, seek the assistance of a tax professional whenever you have any questions about your tax situation.

Debra Taylor, CPA/PFS, Esq., CDFA, writes on tax and retirement planning for Horsesmouth, an independent organization providing unbiased insight into the critical issues facing financial advisors and their clients.