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Initiating Year-End Tax Planning Discussions to Reinforce Client Relationships

Four key tactics for generating results

By Scott Rawlins

As the season turns and the year winds down towards Thanksgiving and Christmas, most financial advisors send their clients a holiday card or a basket of goodies. Those efforts are genuinely thoughtful, and they are doubtless appreciated by the vast majority of advisors' clients.

But if financial advisors really wish to prove that they keep their clients' interests foremost in mind, it may be even more productive to focus a little further ahead past the holidays: For if the year is coming to a close, doesn't it stand to reason that the hard, cold reality of tax season – with all of the personal finance implications that come with it – isn't far behind?

Increasingly, financial advisors – especially those who don't come from a tax background or hold tax credentials – are coming to recognize the value of supporting clients with the application of tax-savvy wealth management strategies. With taxes becoming ever more burdensome and complex, the inclusion of tax-relevant advice as part of a holistic financial plan has become an increasingly relevant consideration for even the most ordinary and uncomplicated investor accounts.

Similarly, the marriage of a financial advisory practice with good tax counsel – whether embodied in the same individual professional, or as part of a practice's total in-house offering, or through "alliance relationships" between like-minded financial and tax advisors – has become increasingly central to an appropriately well-rounded, full-service wealth management capability.

Regardless of the structure it takes, one of the notable advantages of including tax strategies as part of the financial planning process is that it affords a natural motivation for a financial advisor to reach out to his or her client and schedule a meeting – And such meetings are rarely declined by clients who appreciate forward-looking advice.

Mining the Form 1040

The process begins, of course, with a review of the previous year's Form 1040 tax return. For a tax-knowledgeable advisor, the Form 1040 includes a wealth of information – often not considered by the average financial advisor – that yields a host of items to examine and consider for taking tax-savvy actions. In this regard, there are four key tactics to bear in mind:

1. Focus initially on the low-hanging fruit. From even the most uncomplicated tax returns, several issues often jump out and beg for tax-wise consideration. Going line by line on the Form 1040, for instance, we see such issues as the following, just to name a few:

- Interest income (line 8a). This raises the question of whether the client would benefit from tax-free municipal bonds rather than taxable instruments. A sharp calculation will show a client how best to make use of this opportunity.
- Dividend income (line 9a or 9b). Since dividend income is taxable, perhaps a client's dividend-yielding stocks would be better placed in a tax-deferred account, such as an IRA, or a tax-free account like a Roth IRA. Certain stocks – depending on tax liabilities – might be better off sold out of one account and bought back into another.
- Retirement plan savings (line 28). Is the client saving enough? Is the client making full use of retirement plan contributions?
- College savings accounts (line 6). Do 529 accounts make sense for this investor? How much to invest, and at what allocations?

2. Pay attention to areas that can yield significant additional "alpha" but demand more sophisticated tax strategies. Stretching a little further up the tree can yield significant benefits, especially if a financial advisor is able to work in close concert with an expert tax advisor. For instance:

- LIRPs. High income earners who are excluded from participating in a Roth IRA may benefit from a Life Insurance Retirement Plan (LIRP). A LIRP can provide a long-term accumulation vehicle that grows tax deferred and can be used to help supplement retirement income. It can also provide loved ones with a death benefit to help replace lost income.
- Passive activity losses. Passive activity losses that are not allowed in the current year are carried forward until they are allowed either against passive activity income, against the special allowance, if applicable, or when the client sells or exchanges the entire interest in a fully taxable transaction to an unrelated party. It may be beneficial to review current and prior year passive activity losses to gain full advantage of their benefit.
- Business owner buy-sell agreements. The death of a business owner may lead to internal chaos, loss of customers and an interruption in revenue flow. A buy-sell agreement funded with life insurance may help maintain the regular flow of business despite the suddenly disruptive tragedy.

3. Don't wait until tax season – next April may be too late. Some benefits need to be addressed during the current tax year and can't be implemented next April. All too often, tax advisors bring up opportunities when preparing the prior year's taxes in April. The client promises to implement them for next year, but then next year rolls around and again an opportunity has been missed. The financial advisor can help act as a vital "ringmaster" in concert with the client's tax advisor well in advance of April on a number of opportunities, including the following:

- Tax loss harvesting. For many investors, tax loss harvesting is the single most important tool for reducing taxes now and in the future. It can save on taxes and help with diversifying a portfolio, but these losses need to be booked before year end.
- Required minimum distributions. Clients need to make sure they are taking the appropriate amount to avoid a 50% penalty or can avoid taxes entirely by having distributions sent directly to a qualified charity.

4. Look ahead to prepare for next year's tax law changes. As we saw this year, changes to the tax codes caused some investors to pay additional taxes in 2014. For example, the 3.8% additional net investment income tax on capital gain, dividends and taxable interest for high-income accounts caught many taxpayers by surprise. But in some instances, they could have anticipated such a development by shifting assets to an annuity for tax deferral or to a more tax-advantaged investment allocation to mitigate their exposure to the additional tax burden.

As mentioned, these strategies demand the combination of good tax insights with careful holistic financial planning. Admittedly, this demands a lot of detailed attention to each account, which a busy financial advisor may not always believe that he or she has time to commit.

Fortunately, technology is beginning to address this matter. Increasingly, we are seeing software tools become available that can automatically run through a tax return and individually flag financial planning opportunities and vulnerabilities based on the client's tax return. These are scalable tools that may not always require a financial advisor to come from a strong tax background, but can enhance the ability of financial advisors to get a running start on working with their clients' tax advisors on a highly efficient basis.

It's become cliché to talk about how the only certainties in this life are death and taxes. But when it comes to practice management, there's no doubt that financial advisors can immeasurably strengthen their client relationships by putting in place the right process for a tax savvy wealth management approach – And it all begins by getting ahead of year-end tax planning.

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