

Financial Planning Using a Client's Form 1040

By: Michael David Schulman, CPA/PFS

By now, tax season is over. Clients have received their tax returns, praised their return preparers for getting them their refunds (or blamed them for a balance due), and are about to file their returns away. Perhaps the returns will be needed for a mortgage, a business loan, or a financial aid application. Other than that, they are likely to be ignored.

Many CPAs never follow up with their clients after tax season. They deliver the returns, send a bill, and say “see you next year” as they wave goodbye.

With the difficulties facing our economy, CPAs can provide valuable assistance to their clients by taking some time after busy season to use the tax return as a guide to helping their clients deal with the current economic difficulties. A tax return is an excellent point at which to begin the personal financial planning process. While clients might feel threatened if asked to complete a lengthy financial planning questionnaire, starting with an already prepared document is easier on the client and is a natural transition to financial planning.

This article discusses how to use the basic Form 1040, U.S. Individual Income Tax Return, and the associated Schedule A, Itemized Deductions, to begin the financial planning process. For clients who do not realize that their CPA provides financial planning services, it is a natural way to strengthen the relationship.

Using the Form 1040

The following are points to consider in reviewing Form 1040 for financial planning ideas.¹

Filing Status (Lines 1–5)

If a client is using the “married filing separately” filing status because the marriage is dissolving, review his or her beneficiary designations to see if changes are necessary. For example, a client going through a divorce might want to remove her husband as beneficiary of a life insurance policy and name her children instead. Once the divorce is final, wills, trusts, powers of attorney, life insurance and annuity beneficiary designations, and other advance directives will all need to be reviewed.

Dependents (Lines 6a, 6b, and 6c)

Dependents are usually the client's children or parents. For dependent children, consider education planning and the need to fund future tuition costs. Ask whether clients have a will; they should have one that names a guardian for their children, even if they do not have a taxable estate.

If they have a dependent parent, ask similar questions about how they are paying for their parent's support. Does the parent need nursing home care? Should the parent purchase long-term care insurance to defray future medical costs?

Alternatively, should the client purchase long-term care insurance for his or her parents? Ask if the parents' estate plan is in order.

Wages and Salaries (Line 7)

Are clients funding any employer-sponsored 401(k) or cafeteria plans? This is especially important when the employer provides a generous match of contributions. (In what other way can a client obtain an immediate return on an investment?) With the current economic slowdown, many employers are cutting back on matching contributions. Nonetheless, it is still advisable for clients to contribute to their plans.

For clients with retirement plans, review their portfolio's diversity. Is it time to change investments? For older clients, how has the economic crisis changed their plans for retirement? Do clients have adequate disability coverage to protect against loss of earning power?

Dividends and Interest (Lines 8a, 8b, 9a, and 9b)

Ask clients if they are satisfied with the returns on their portfolios. Discuss the portfolios' diversification. Evaluate the taxability of the portfolios—is more tax-exempt income an appropriate objective? For older clients, is it appropriate to add guaranteed investments, such as an annuity?

¹ Line numbers are from the 2008 Form 1040.

Alimony Received (Line 11)

Spouses receiving alimony often need cash management assistance and help with budgeting. A spouse who is home with children and unable to undertake full-time employment may need assistance in finding adequate health care coverage. Since alimony is taxable, it is important for the client to set aside an amount from the alimony for taxes.

Self-Employment Earnings (Lines 12 and 17)

Discuss the advisability of incorporating the business or forming a limited liability company to protect personal assets. Is the business properly insured? As with wage earners, is there adequate disability coverage? If a client is using his or her home for business purposes, will homeowners' insurance provide adequate coverage? If the client has employees, does he or she also provide workers' compensation and disability insurance for them? Is there a deduction for a retirement plan (line 28)? If not, discuss retirement savings with the client. If so, is the funding adequate?

Capital Transactions (Line 13)

If the return shows substantial losses, perhaps it is time for a professional portfolio manager or investment adviser. Frequent trading may be a sign that the client is not planning for the long term. Are unrealized holding gains and losses being properly used in the client's portfolio? Has the client developed an appropriate strategy for the use of loss carryforwards?

IRA and Pension Distributions (Lines 15 and 16)

Ask why the client is taking distributions. Many clients do so to satisfy short-term cash needs. Remind the client of the tax penalties on such withdrawals. Can a short-term line of credit or loan be obtained? If the distributions are normal distributions, discuss the amount. For 2009, the requirement to take a required minimum distribution has been suspended, so clients should not automatically take a

distribution.² Review the beneficiary designation. Are the beneficiaries still correct? Or has a remarriage been overlooked? Is the minimum distribution calculated correctly?

For clients who have inherited IRAs, the rules are complicated and the penalties for not taking the correct amount are substantial. Review them with the client.

Rental Real Estate, Royalties, Partnerships, and S Corporation Income (Line 17)

Discuss the nature of the client's investments. If there are unusable losses, should the investment be sold?

Caution: Often the basis will be zero because depreciation deductions have been taken.

IRA Deduction (Line 32)

Is the client eligible for a deductible IRA? If so, was a deduction taken? If the client has an IRA, should it be converted to a Roth IRA while portfolio values are low? Again, now is the time to discuss retirement planning. Is the client happy with his or her retirement plan? Review asset allocations and beneficiary designations.

Overpayment (Line 72)

Many taxpayers receive a tax refund. It is probably better to decrease withholding and use the increased cash to reduce debt or invest in an IRA instead of making an interest-free loan to the government.

Itemized Deductions, Schedule A Medical Expenses (Schedule A, Lines 1-4)

If the client has deductible medical expenses, review the medical coverage. If medical costs are for a parent, a more comprehensive review is required. Also, remember that the premiums for long-term care insurance are deductible.³

Interest Expense (Schedule A, Lines 10-14)

If a client is deducting mortgage interest, discuss the suitability of refinancing to lower costs. A mortgage is also a reason to

discuss the purchase of additional life and/or disability insurance.

Even though personal interest is no longer deductible and therefore will not appear on Schedule A, inquire about clients' debt condition. In the past, financial planners might have suggested taking a home equity loan to repay excessive credit-card debt. With the new economic conditions, home equity loans are not always available. This is an excellent opportunity to discuss budgeting with clients.

If a client has investment interest expenses, discuss the suitability of purchasing stocks on margin.

Charitable Contributions (Schedule A, Lines 16 and 17)

In lieu of cash contributions, see if there is appreciated stock that could be donated to avoid the capital gain while achieving charitable objectives. For clients with charitable intent, discuss charitable remainder and charitable lead trusts to provide current tax deductions.

Other Miscellaneous Deductions (Schedule A, Line 28)

If a client has a variable annuity contract with a surrender value less than its cost basis, is now an appropriate time to surrender the contract? Will the tax benefit of the loss exceed any possible surrender penalty?

Conclusion

2008 was a difficult year for many clients, and 2009 promises to be challenging as well. Spending a few minutes with clients reviewing their tax returns will lead to an increase in billable fees as well as a better and more personal client relationship.

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EditorNotes

Michael Schulman is the owner of Schulman CPA, an Accountancy Professional Corporation, in New York, NY.

² Sec. 401(a)(9)(H), as amended by the Worker, Retiree, and Employer Recovery Act of 2008, P.L. 110-458.

³ Sec. 213(d)(10).