PacificCPE

COURSE
40856A

Income Tax Guidance Within Financial Planning

Tax planning is a natural extension of the services CPAs already provide, but integrating it into a broader financial plan requires a distinct framework. This course covers key income tax issues relevant to financial planners, including how tax liability is calculated, filing status considerations, and the tax-related topics most important to client discussions. Whether you're deepening your planning expertise or looking to connect tax strategy more intentionally with clients' overall financial goals, this course offers real-world relevance.

CREDIT HOURS **2** | FIELD OF STUDY **BUSINESS** | EXAM QUESTIONS **10**

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LEARNING ASSIGNMENTS AND OBJECTIVES

Assignment

- Study the full course materials included here.
- Complete the review questions after each chapter.
- Answer 10 final exam questions.
- Final exam is scored immediately, 70% or better passes.
- Certificate of completion is available in your account.
- Failed exams can be retaken free of charge.

Course Objectives

- Recall the characteristics of various business entities.

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TABLE OF CONTENTS

CHAPTER 01

Dispensing Advice On Income Tax 4

1.01 Filing Status Issues 5

1.02 Seven Steps To Calculating Income Tax Liability 7

1.03 Business Entities 14

1.04 Tax Planning Strategies 27

1.05 Like-Kind Exchanges 28

1.06 Income Recognition 32

Test Your Knowledge 37

Final Exam Copy 47

Glossary 44

Index .....

Chapter 1: DISPENSING ADVICE ON INCOME TAX

Chapter Objective

After completing this chapter, you should be able to:

- Recall the characteristics of various business entities.

Rattiner's Secrets

A common question I get from clients is "What can I do tax-wise to minimize my tax liability?" Sometimes the lines are not that clear for our clients. I have had many clients over the years who want to make their sole purpose for investing to avoid paying income tax. As I mentioned in the last chapter, if the client is paying income tax on an investment, chances are that person has made some money on that investment, which would be a good place to be!

Whether you work in the tax area or not, you always must deal with erring on the side of extreme caution. Certainly, if you don't provide tax advice, reach out to an affiliate or to your client's personal CPA. I proceed to answer clients with "We have to make sure we practice tax avoidance vs. tax evasion." I'm generally asked, "What's the difference, Jeff?" I say, "20 years!"

In all seriousness, tax avoidance is the arranging of financial affairs to minimize tax liability working within the law while tax evasion involves the reduction of taxes through illegal means. There are plenty of ways to work within the system legitimately to minimize the tax liability paid. We'll cover that throughout. Also, the term *taxpayer* will be used more often than client in this chapter. Lastly, this is not an income tax textbook. There are plenty of good ones around. This chapter covers the practical applications for how you can help your clients in this area.

Planner Income Tax Issues for Client Discussion

- Filing Status Issues
- Seven Steps to Calculating Income Tax Liability
- Business Entities
- Section 179 Deduction
- Tax Planning Strategies
- Like-Kind Exchanges
- Income Recognition

Since we are all required to file Form 1040 (individual tax return) if the income thresholds warrant it, a good place to start is with selecting the appropriate filing status.

FILING STATUS ISSUES

The specific amounts of gross income that must be generated before an individual is required to file an income tax return depend on the individual's filing status. However, in all cases, this floor amount is equal to the standard deduction (for the applicable filing status). For example, a single individual/married couple is not required to file an income tax return so long as their income does not exceed the standard deduction for that year, which is an indexed number. There are no personal exemptions allowed.

Tax implications of marriage

While tax implications should not be the likely reason for (or for not) getting married, they should be considered. The most important of these tax implications is the filing status that should be chosen.

Filing status is determined on the last day of the tax year (December 31). I have seen people purposely get married or divorced on the last day of the calendar year. Generally, married filing jointly (MFJ) is beneficial. However, the so-called "marriage penalty," while greatly minimized, may still kick in when both spouses are working and their combined income moves the taxpayer unintentionally into a higher tax bracket. When MFJ is less expensive is when one spouse is the main breadwinner. Essentially, you are dividing that money over two individuals (MFJ), so the overall tax liability is less.

As an alternative to married filing jointly, married individuals may file separate returns. However, this is rarely advantageous unless one spouse wishes to avoid the joint-and-several tax liability that is inherent in married filing jointly status (as discussed above) or if one spouse has substantial medical expenses. By filing separately, the base adjusted gross income (AGI) threshold to exceed is lower, thereby making the amount to be written off higher.

There are five types of filing status that an individual may use in figuring and reporting their federal income tax liability:

1. **Single (S):** Generally, this is any unmarried, legally separated, or divorced individual who does not qualify for any other filing status. The most notable exception to this status is a married individual who lives apart from their spouse, as of the last day of the calendar year, and maintains a household for a dependent child (or children). If this is the case, the taxpayer may file using "head of household" tax status.
2. **Head of household (H/H):** This is an unmarried (or, in some cases, married) individual who has lived apart from their spouse for the last six months who maintains a household for a

dependent child or children as of the last day of the calendar year. Accordingly, the taxpayer may use a favorable set of income tax rates and brackets that falls between single and married filing jointly.

3. **Married filing jointly (MFJ):** A husband and wife may file a joint income tax return, even though one spouse has no income or deductions, so long as they are not legally separated or divorced as of the last day of the calendar year. The advantage of this filing status is a very favorable set of income tax rates and brackets. The disadvantage of the status is that the husband and wife now assume "joint and several liability" for the reporting of income and payment of the tax, meaning that if one spouse does not pay the tax (for example, is absent from the home), the other spouse is liable for that payment. Note that it may be possible for the other spouse to claim "innocent spouse" relief under the tax law, although it is very difficult to qualify for such relief under current law (as previously stated). A surviving spouse may also file using MFJ status for the year in which the death of their spouse has occurred.
4. **Married filing separately (MFS):** A husband and wife may also file separate tax returns, although at the expense of sometimes punitive tax brackets and tax rates. When filing separate returns, each spouse reports only their own income and applicable deductions and tax credits. Typically, MFS status is used only by married individuals in the process of divorcing and who do not wish to assume joint and several liability for the tax reporting of their soon-to-be ex-spouse (as stated above).
5. **Qualifying surviving spouse with dependent child status:** A taxpayer with a dependent child whose spouse has died during the current year and for up to two years thereafter may take advantage of this filing status. For example, an individual with a dependent child whose spouse has died during the year 2024 may file as a qualifying widow(er) for taxable years 2025 and 2026 with dependent children. However, this is only the case where the surviving spouse remains unmarried for taxable years 2025 and 2026. It needs to be emphasized here that qualifying widow(er) status entitles the surviving spouse only to joint income tax rates; the status does not authorize them to file a joint tax return.

Rattiner's Secrets

Funny story. Many, many years ago, during a discussion on filing status, I had a student in one of my Fast Track classes tell me how she filed her tax return. She said, "Jeff, I have been married the last 23 years . . . happily . . . but I have been filing married filing separately." As a fellow New Yorker, of course I said "Why?" And she proceeded to tell me that she had no idea what her husband did for a living or what he earned! I said, "Really?" She said they made $30,000 a year but that couldn't be right. They had live-in help, many expenses, and their real estate taxes alone in Westchester County, NY, were over that. Looking at my own vulnerability, I said, "Please don't say anymore and I'll give you all 'A's!"

Well, that last sentence is a little bit of an exaggeration, but here's the point from all of this. When you sign a tax return jointly, you are both jointly and severally liable. That means even if one spouse makes all of the income and the other spouse does other relevant but unpaid work, and the paid spouse does something wrong, deliberately or not, then the unpaid spouse can be liable for 100% or more of the tax liability, including penalties and interest. Some clients ask me if the innocent spouse rule protects them. My response is that in all the years I have done this and asked this question during my CPA presentations, I can probably count on one hand how many CPAs' clients actually were able to use that strategy to their advantage. I also have this discussion with clients who think they may be getting a divorce (see Chapter 2 of course 40859A), when speaking with both of them together, or if a prospect visits my office and tells me their situation. Lesson here: Better safe than sorry!

SEVEN STEPS TO CALCULATING INCOME TAX LIABILITY

The individual tax return (Form 1040) has many steps and we'll cover the first seven. By the way, the estate tax return (Form 706) is a similar setup for the first seven steps, but more on that in Chapter 1 of course 40859A.

Seven Steps to Calculating Income Tax Liability (Brackets Based on Filing Status):

Step 1 – Total gross income (broadly conceived).

Step 2 – Subtract your above-the-line deductions from gross income to find AGI.

Step 3 – Determine itemized deductions to find out if they exceed the standard deduction amount. Deduct the greater of total itemized deductions or the standard deduction.

Step 4 – Subtract your total itemized deductions or the standard deduction amount to determine your taxable income.

Step 5 – Find your tax from either the tax tables or tax schedules.

Step 6 – Subtract tax credits, if any, from taxes determined in Step 5.

Step 7 – Amount equals income tax liability.

Step 1: Gross income

For federal income tax purposes, gross income is defined as all income from "whatever source derived except those items that are otherwise specifically excluded (by the Internal Revenue Code)." See IRC Section 61(a). This includes not only legal income but also illegal income (which is how Al Capone was caught and pleaded guilty to tax evasion on June 16, 1931). Implicit in the definition is the assumption that any economic benefit received by the taxpayer (for example, as the result of an employee benefit) is taxable, unless there is a specific exception. Thus, here are some commonly included items of gross income for any taxpayer:

- Alimony (if made under a divorce or separation agreement executed before January 1, 2019)
- Award for special services
- Bonus paid for prior year's service
- Commission on sales
- Dividends or interest income received
- Forgiveness of debt (other than bankruptcy)
- Gambling income
- Honorariums
- Income earned on gifts or inheritance
- Jury fees
- Pension (and retirement) income
- Prizes

- Rents and royalties
- Salaries
- Scholarship to nondegree candidates for room, board, and incidentals
- Self-employment ("Schedule C") income
- Wages
- Tips and gratuities
- Unemployment compensation

Alternatively, items excluded in the Code include some type of charitable, social, or even political purpose, or essentially for the greater good. Here's a partial list of some items of excluded income (or economic benefit received) by IRC statute:

- Accident and health benefits received
- Alimony (if made under a divorce or separation agreement executed before January 1, 2019)
- Forgiveness of debt in bankruptcy
- Military combat pay
- Gifts
- Gain from sale of personal residence (limited)
- Inheritances
- Interest from municipal bonds used for public purposes
- Life insurance death proceeds
- Scholarship to degree candidates for tuition, fees, and books
- Social Security benefits (partial)
- Bargain purchases by employees (qualified employee discount)
- Child support payments received
- Christmas gift of nominal value
- Compensation for damages to personal rights
- Awards (unsolicited) in recognition of scientific achievement
- Lodging and meals furnished for the convenience of the employer
- Educational assistance payments provided by employer (limited)
- Miscellaneous fringe benefits, such as employee discounts and working conditions benefits

Step 2: Adjustments to income: above-the-line deductions

Once gross income is determined by the taxpayer or by their tax preparer, the next step in the federal income tax formula is to compute the taxpayer's adjusted gross income. To do this, certain deductions are permitted, commonly referred to as "above-the-line" deductions, with the "line" being the amount of the taxpayer's adjusted gross income.

Here is a list of the major deductions that may be taken above-the-line and without the necessity of itemizing the taxpayer's total deductions:

- Ordinary and necessary business (Schedule C) expenses
- Capital losses
- Alimony paid to taxpayer's ex-spouse – for divorce decrees dated before January 1, 2019
- Moving expenses repealed beginning in 2018, except for members of the military
- Interest on education loans/student loan interest deduction – subject to phaseout
- Deductible traditional IRA contributions
- Payments to Keogh plans, Simplified Employee Pension Plans (SEPs), and Savings Incentive Match Plan for Employees (SIMPLEs)
- Self-employed health insurance deduction (deductible up to 100% of premiums paid)
- Employee contributions to health savings accounts (HSAs)
- Deduction for one-half of self-employment tax paid

This takes the taxpayer to AGI.

Steps 3 and 4: Determine the higher of the standard deduction or itemized deductions

The taxpayer would take the higher of the standard deduction or itemized deductions as the below-the- line deduction. With the standard deduction, no receipts are necessary, and the taxpayer would take the allowable amount in that year based on filing status (discussed above). With itemized deductions, the taxpayer would need receipts exceeding the standard deduction amount to receive any benefit. Taxfoundation.org estimates that about 86.3% of households take the standard deduction rather than itemizing their deductions.

For example, allowable itemized deductions on Schedule A of IRS Form 1040 consist of medical expenses, taxes, interest, charitable contributions, and casualty losses with certain limitations, and include the following:

- Medical expenses must exceed 7.5% of AGI.
- Taxes consist of real estate, personal property, state, and local. The state and local taxes (SALT) deduction is capped at $10,000 for higher income taxpayers.)$40,400 in 2026 for incomes below $505,000).