Tax Planning Strategies

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Tax planning strategies are commonly addressed in December as small business owners and other taxpayers start to freak out about bringing in the New Year. However, tax planning is an ongoing and fluid dynamic, and it should be performed methodically throughout the year. Sure, we can slam things together on December 31, but that is operating in crisis mode. Rather, operating in planning mode throughout the year allows for better decisions and better tax savings.

Ongoing Tax Planning

Tax planning starts with the tax return. Huh? The best practice is to use the previous year's tax return as the anchor for tax projections and what-if scenarios. Commonly a small business owner will contact us and ask us to calculate his or her tax obligation in isolation to the rest of their world. While not impossible, this is an incorrect approach. It is surprising the push back we receive when asking for prior tax returns, "Why do you need them?" is a common retort. We need them for a ton of reasons… some are actually good ones (and no, we don't pile on bad ones just to look complete, but we certainly want to).

First, we need to look at the total household income and all the income sources. Does your spouse work? Do you have rental income? Pension income? Let's say your business earns $100,000 net income after expenses. Let's also say your spouse earns $100,000 as a W-2 employee. Separately each $90,000 is in the **12% marginal tax bracket** after some assumed tax deductions. But… when we combine the incomes, they collectively are in the 22% or even 24% marginal tax bracket. Almost double the tax rate!

Another situation can creep up. Let's say your business earns $150,000 net income but your spouse earns $60,000. When your spouse's employer processes payroll, the payroll tables can only make total household income assumptions on based on your spouse's pay rate. Naturally the payroll tables will under-withhold… and this can happen even when claiming Married 0 on your W-4. This miscalculation will show up on the tax return as a drastic reduction in tax refund or perhaps a tax due. Yuck!

Next are some tax return nuggets that we can use again such as, is there a loss carry-forward? Are there unused tax credits?

So, proper tax planning starts with the tax return so the total household income including withholdings are taken into account. From there we need to poke and prod, and gather some data. Our tax planning questionnaire helps you organize your thoughts and jog the "oh, yeah, I want to talk about that" moment.

Also, we get asked all the time "Am I doing everything to save taxes?" The answer of course requires a deep dive into several various tax reduction strategies. The button below is a good place to start.

Tax Plans

As mentioned earlier, tax planning starts with the tax return, and from there we have some fun. Let's put aside **small business tax deductions** and other tax reduction strategies for a moment. Tax Plans, the actual deliverable, are fairly basic, but are super critical. We don't mind telling you bad news in August, but you shouldn't be surprised by it in April. There are worse things, but one of the challenges of small business owners is having money in the bank and not knowing how much is theirs. Can I buy a new car, or should I look around for a used one? Your level of frugal-ness is commonly tethered to how much cash you have. Not always. Not dollar for dollar. But certainly influential.

When WCG prepares a tax return we automatically prepare a Tax Plan for the follow year. From there we tweak it and stress-test it again in June and July, and again in November and December (provided there is a greater than 10% change in income from the current tax projection). A quick word; tax planning and Tax Plans do not require NASA precision, however, they do require slightly above bar napkin quality too. Far too often we entertain conversations from taxpayers and small business owners who created elaborate spreadsheets with fancy formulas and color-coded cell references. We smile, and say, "Neat." The proof is in the tax return pudding… let's fire up the beaters shall we?

As such all our Tax Plans end in creating mock tax returns. Again, tax returns are the ultimate measure of tax obligation using current tax rates, tax law, tax deductions, tax credits and all the other things you'd expect on an actual tax return.

Planning for Tax Neutrality

Tax planning involves two objectives; one is to minimize your tax obligation. Or as one of our clients said recently, "You help minimize my taxable surface." Cool. We like that terminology. After minimizing your tax obligation… err… minimizing your taxable surface, we ultimately need to compute your tax obligation. Our second objective at WCG is to achieve tax neutrality on your tax returns by aiming for a $1,000 refund from the IRS and $500 refund from the state. How do we do this? If you are an S Corp shareholder, we increase your income tax withholdings on your **officer salary** so that at the end of the year we land on the targeted annual tax withholdings. If we can achieve this through payroll, then we recast estimated tax payments to again land on the targeted annual tax payments.

Far too often, other tax professionals and CPAs compute estimated tax payments in spring for the rest of the year and then freak out in December when those estimates are not creating tax neutrality. WCG and its gaggle of **Colorado Springs CPAs** does things differently by visiting tax planning and bracketing your tax obligation throughout the year.

Again, we define tax neutrality as refunds from the IRS and the state. Those are our objectives with tax planning, but they don't have to be yours. We commonly hear clients say, "I don't mind owing $5,000. I just don't want to owe $25,000." Fair enough. We also hear taxpayers especially small business owners who say, "I need the cash right now for a new house / business expansion. I'll worry about next time, next time." Again, fair enough. As long you know your tax bill through accurate tax planning, we've done our job.

Some people claim, "I can earn more with my money in my pocket than giving it to the IRS." Sure… but keep in mind your return on investment in a cash-equivalent investment is probably around 1% annually and you run the risk of being assessed an underpayment penalty by the IRS. If you need your cash for a house down payment or buying more inventory / equipment, that is one thing. But to park it in a CD because you want to beat the IRS, that is fool's gold.

Business Tax Deductions

We don't want to spend a lot of time on **business tax deductions** in this blog post. We have written a whole chapter in our **Taxpayer's Comprehensive Guide to LLCs and S Corps** on business deductions. We have other blog posts on **buying automobiles**, home office deductions, **maximizing 401k** or defined benefits pension contributions, **adding your spouse to payroll**, **Accountable Plan** reimbursements, **Sutter Rule** and all kinds of other cool things.

But we need you to keep a few things in mind. First, you buy stuff for operational need (or for fun). If we can make your expenditure a tax deduction or a tax credit, then awesomesauce all around. But! Do not spend money just for the tax deduction. If your marginal tax rate is 24%, spending $10,000 saves you $2,400, sure, but you still have $7,600 in cash leaving your body.

Far too often we hear "but it's a business write-off" at a cocktail party… just because it is a business tax deduction doesn't mean the cash isn't real. Houses are green and hotels are red in Monopoly, but your cash is still your cash.

Second big consideration is this… at times we run out of bullets in tax planning gun. The quickest way to reduce your tax bill is to make less or spend more. Both of those options sound silly. Again… same cocktail party… different crazy person… and we hear, "I don't want to make too much money because it'll just be taxed." Nonsense. The highest marginal tax rate is 37% which means for every dollar you earn you still take home 63 cents. We understand your effort might not be worth 63 cents… and that is a personal thing… but 63 cents isn't 91 cents.

91 cents?! In 1965, the marginal tax rate at $400,000 was 91%. Sure, $400,000 is a crapton of dough… and sure… it might have made sense to stop working in October if you are only taking home 9 cents on the dollar. Today, that thinking might be short-sighted. According to **Investopedia in an October 2019 article**, the U.S. ranks 21st in terms of effective tax rates for married people with Turkey, Denmark, Finland, Netherlands and Norway rounding out the top 5 highest tax rates.

The trick with small business tax deductions is to find dollars that are already leaving your body and that you are comfortable with spending from a budget perspective, and attempt to find a business connection. Was that meal with an associate who might also be a friend a **business meal tax deduction**? Could I justify a home office and reduce my non-deductible commuting expenses? I need a new car, can it be a business car?

End of Year Tax Planning

We don't want to spend a lot of time on **year-end tax planning** either since we have additional blog posts and webpages devoted to this topic. The recurring themes remain the same with 401k and IRA contributions, charitable donations, profit harvesting your investments, paying your bills earlier, income shifting, paying bonuses sooner and other things.

Contrary to popular belief, there is no secret tax deduction club that only a few of us know about, and even fewer talk about. This isn't fight club, OK? Thanks to all the internets the speed and volume of data simply puts all ideas and thoughts on the forefront. Are there little tricks that some accountants aren't aware of? Sure. Do accountants routinely inject their level of risk aversion into your decision-making? Yes. At WCG we will ensure ethical guidelines are met and clear tax positions are followed. But please do not call us and let us know that your neighbor… the one with two homes and a yacht… does not pay taxes. Stop believing everything heard at a cocktail party.

Having completed our rant, we swim in the grey waters with slivers of white and black. We will provide you with options, arguments and counter-arguments. Ultimately it is your life, and we will offer guidance as you walk thru it.*Jason Watson, CPA is a Senior Partner of WCG Inc., a business consultation and tax preparation CPA firm located in Colorado Springs, and is the author of **Taxpayer's Comprehensive Guide on LLC's and S Corps** which is available online and from mostly average retailers.*