

Nagel on Finances: Asking the right questions

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Recently, a client called to ask why she owed so much tax this year and what she should do about it for next year.

That's a common question when surprised by an unexpected tax liability.

But is it the right question? Or should the question be: Why is this so unexpected?

2021 was a crazy year for all of us. Many things happened unexpectedly. Only a few events created increased tax liabilities and that is generally the case.



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Money managers across America distributed large capital gains distributions late in 2021 that caught many taxpayers off guard. You do not know when and how much those distributions might be, and rarely do you get advanced warnings.

Even if you did, most of us would smile and think to ourselves what smart investors we have become.

Few of us ask the questions: What about the tax effect? Will they withhold taxes? Should I make estimated payments?

The same thing will happen when selling real estate, especially right before year end, the issues are just more complicated. Most taxpayers need a little help in planning ahead.

If you sold a business or a partial interest in a business, you better be prepared for tax time. And until you are, do not spend all you received. Part of it may not be yours.

What about that promotion or pay raise? Hopefully, your annual pay increase may be higher than the past to help offset inflation.

But have you asked: will my withholding need adjusted also? It likely will, especially if you owed when filing last year and your new salary causes you to jump into a new marginal tax bracket.

Let's focus on that word: marginal. Your effective tax rate is your total tax divided by your taxable income.

But your marginal tax rate is the highest tax bracket for your taxable income. You can find your marginal rate in the tax tables at the IRS website, among other places.

We report to every client their marginal rates with each tax return. It helps taxpayer and tax planner, alike.

In any given year, the next dollar you earn or receive will be taxed at that marginal rate. And in some cases that new rate can be much higher than the past, especially if you cross more than one bracket.

Do you know how tax rates vary for capital gains versus ordinary income and how the actual tax is calculated? Doubtful, but your CPA does.

If the right question is: what can I do to plan ahead for what I will owe, then the next question becomes: what can I do to make that liability lower?

This is the heart of tax planning.

For most of us, good tax planning is simple, fundamental and practical. Increase your contributions to your retirement plan by the amount of new income whenever you can.

You and your family will benefit in a growing amount for years.

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