Tax Rate

ASSESSMENT GUIDE

Tax Rate (Tr) is the percentage of a client's current year annual gross income (not necessarily the tax year's income) being allocated toward tax payments.

Elements®
Financial Planning System

Tax Rate

Assessment Guide

What is it?

Tax Rate (Tr) is the percentage of a client's current year annual gross income (not necessarily the tax year's income) being allocated toward tax payments.

CALCULATION

$$\frac{\text{Total Annual Taxes Paid}}{\text{Total Personal Income}} = \text{Tax Rate}$$

Total Annual Taxes Paid
÷ Total Personal Income

Tax Rate

Tax payments include federal income tax, state & local income tax, and payroll tax (for 1099s or business owners).

> **Example:** In 2020, a client paid $16,000 toward federal income tax, $6,000 toward state taxes, $3,500 toward state taxes, and $5,400 toward payroll tax as a 1099 employee. The client's current income in 2021 is $165,000, so the estimated Tax Rate is 18.7%.

Why is it important?

For clients, tax payments represent a significant percentage of their cash outflows, making taxes an essential part of their financial plan. While this guide will not go into details around the importance of tax planning, we'll simply note that as advisors, it's important to periodically review a client's tax situation to make sure the client is capturing all the opportunities available to them, reducing the percent of income going towards tax.

How do I use it?

By following the process detailed below, you will be equipped to assess whether a client's Tax Rate is appropriate or if they need to make improvements:

1. **Accuracy:** ensure the accuracy of the Tax Rate inputs.
2. **Assessment:** assess whether the given Tax Rate is appropriate.
3. **Improvement:** Identify areas of improvement

STEP 1

Score Accuracy

In a perfect world, the four cash flow Elements (Savings Rate, Burn Rate, Debt Rate, and Tax Rate) will add up to 100% of annual gross income. But Tax Rate relies on historical tax data divided by current year income, so it can be difficult to obtain a perfect allocation of income. In many instances, your most recently available tax return is 1-2 years old.

> **Example:** Its 2021. A client estimates they'll earn gross income of $100,000 this year. They have not yet filed their 2020 return, so you rely on 2019 tax data. In 2019, the

client's income was lower so tax payments only totaled $12,000. As a result, in Elements, their current Tax Rate is 12%, lower than it's likely to be after filing 2020 taxes.

The client is allocating income in 2021 as follows:

- **Savings = $20,000 = 20%**
- **Spending = $40,000 = 40%**
- **Debt = $15,000 = 15%**
- **Estimated Taxes (2019) = $12,000**

You'll notice that these items total $87,000, falling short of the annual gross income value. This is likely because the tax return data is 2 years older than the other cash flow items.

STEP 2

Score Assessment

Average Tax Rate scores depend primarily on earned income as defined by the IRS. Because there are so many factors that influence tax rate, it is difficult to standardize benchmarks and provide average score ranges.

STEP 3

Score Improvement

Volumes have been written about tax planning and strategies to decrease tax payments now and in the future. This brief list will help you get started as you consider ways you can help clients have a more health tax situation.

1. **What strategies can a client utilize to increase above- and below-the-line deductions?**
2. **Are there any tax credits a client can utilize to reduce tax payments?**

3. Can you find tax savings in the clients:
    a. Investment accounts
    b. Charitable contributions
    c. Businesses
    d. Roth Conversions