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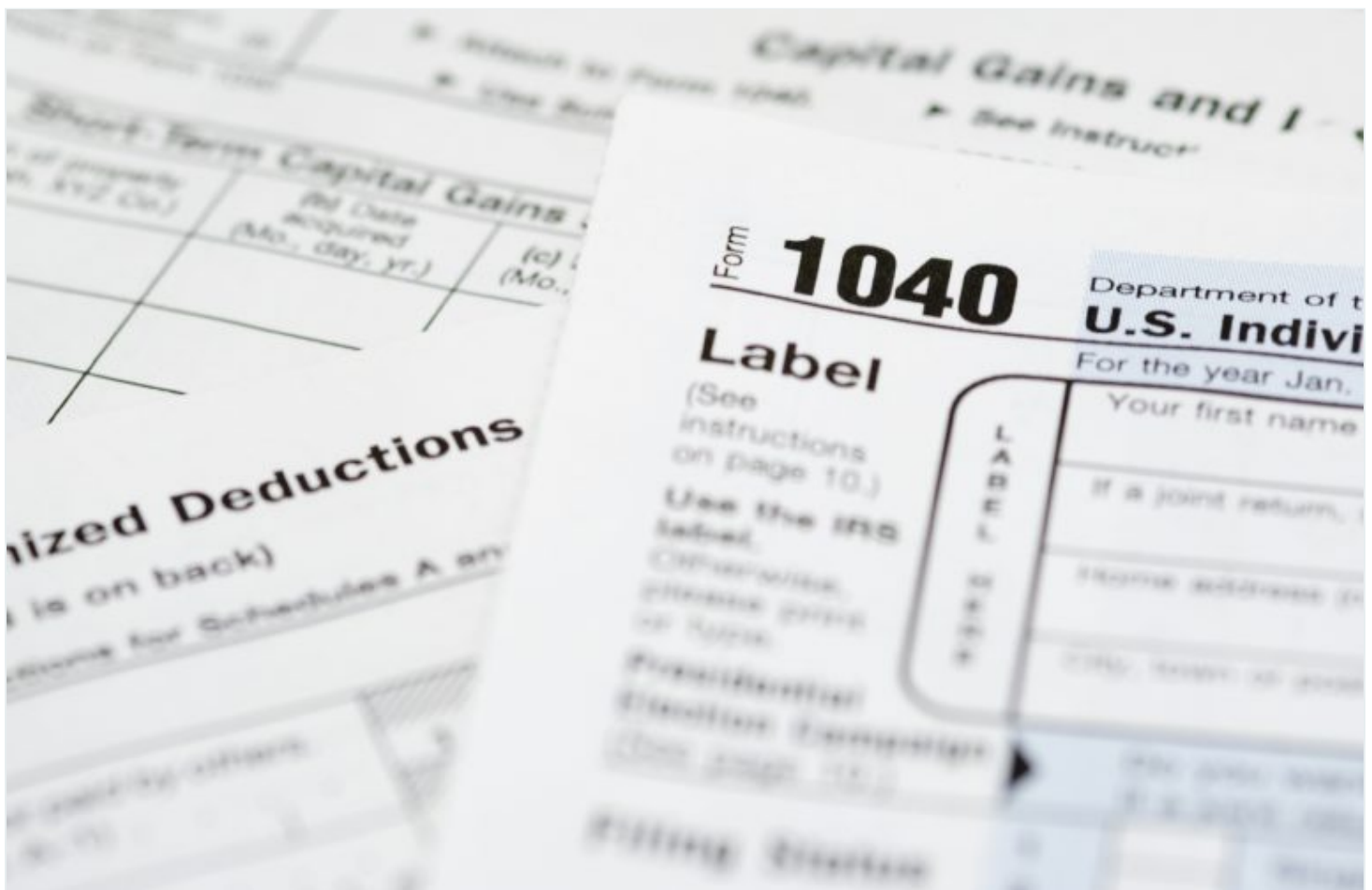
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**PRODUCT & SERVICE GUIDE**

# 3 Income Tax Surprises and Their Warning Signs

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Dave DuVal, EA • Apr. 12, 2016



Wouldn't it be nice if our clients contacted us before making any type of financial transaction with a tax consequence? Unfortunately, many of us as tax advisors are out of sight, out of mind, and out of the loop most of the year, leaving our clients eleven months to make decisions that sometimes result in tax bills that later surprise and shock them. While we can turn these events into teaching moments, a much better option is to prevent them from happening in the first place – whenever we can, of course.

Here are some warning signs that your clients might be considering a move they may regret later – and tips for helping them make informed financial decisions.

## **Retirement Income**

When my clients say they look forward to the day when they can withdraw funds from their retirement accounts penalty-free, my alarms go off. The first thing I do is remind them that a retirement account is meant to support them in their golden years, not to use on vacations, boats and hot tubs now. And while it may be true that soon they'll be old enough to withdraw funds without a penalty, I make sure they understand the tax consequences of doing so. For many taxpayers, the reality of the decision to withdraw doesn't hit until they see their tax bill.

If you do have the chance to influence their choice, a great way to get the point across is to walk your client through the tax calculation and show them on paper how much of their distribution they will pay in taxes versus how much they will receive in their pocket. An illustration such as the ones you can generate using an online 401(k) Early Withdrawal Costs Calculator are quite powerful. From a \$10,000 distribution, for example, a California taxpayer under 59 and a half in the 28% income bracket will receive roughly \$5,300 while paying \$4,700 of the distribution in taxes.

Another common mistake my clients make is believing funds withheld from their retirement plan distributions as federal withholding mean the taxes are paid and that there is no reporting requirement. Unfortunately, the standard 10 percent withholding rarely covers the taxes due, and it certainly doesn't fulfill the reporting requirement – so when your client tells you not to worry, that the taxes have already been paid on his retirement distribution, be alarmed!

## **Forgiven Debt**

Undoubtedly, at some time during your career you will have a client who makes a deal with a bank or credit card company to have some portion of a credit card or mortgage debt forgiven. Later on the client may be shocked to learn that the discharged indebtedness is considered taxable income by the IRS.

Before you look for ways to get your client off the hook by reviewing eligibility for an exception or exclusion, take advantage of the teaching moment and help the client avoid the same situation in the future. The first important concept to explain is “accession to wealth,” which is how the Supreme Court has defined “gross income” for tax purposes. To demonstrate the way in which the cancelled debt makes them wealthier by the same amount as the debt cancelled – on paper at least – present a simple net worth computation before and after the discharge of indebtedness.

In my practice I’ve also worked with taxpayers who believe losing a house to foreclosure results in a tax loss. And while this is sometimes true, there’s a complicated calculation that depends on multiple factors – and in fact a foreclosure could result in taxable income. This is always a big surprise to taxpayers who have been through the trauma of losing a home. Listen for the warning signs and ask the right questions!

### **Gambling Income**

If you happen to have a client who likes to gamble, he or she may come into your office one April with a W-2G, Certain Gambling Winnings, tax reporting document. The surprise for the recreational gambler may not be that the gambling winnings are taxable, but the way in which the taxable amount is determined.

Many taxpayers are unaware of the special rules for calculating gambling gains. While all wagering income is includable in gross income and wagering losses are deductible to the extent of wagering gains, the calculation is tricky. Wagering income is reported first, and then wagering losses that do not exceed the income are separately deducted.

While there is no official definition of a gambling session, it is generally accepted that a gambler can net results in two or more different games if they were the same game played continuously and without cashing out. But since most recreational gamblers incorrectly calculate their total annual wins against total annual losses, taxable income will likely come as a big surprise the first time it happens.

When your client brings a W-2G to the tax appointment, take the opportunity to educate the client about keeping a contemporaneous written log of gambling sessions – even if it was just a one-time event. While that may be true today, tomorrow could be a different story.

There are many more surprises hidden in the tax code. From certain types of legal settlements, to treasure trove and windfall income, to alimony and tips, be on the lookout for warning signs and teaching moments to help your clients avoid making decisions that will end up shocking them when tax time comes.

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