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Advisor Article

A Playbook for Tax Planning

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INTRODUCTION

Many people think about taxes once a year – when April 15th is looming and it is time to file their tax returns. By then, the previous year is already in the rearview mirror and the window of opportunity to make decisions that could have made a difference may have already closed.

There are important differences between **tax preparation** and **tax planning** and understanding them could change how you think about your money – not just in the spring, but all year long.

TAX PREPARATION vs. TAX PLANNING

Tax return preparation happens after the year ends. You gather your W-2s, 1099s, and receipts and give them to your CPA (or use Tax Preparation software) to calculate what you owe – or what you are getting back – and file the return.

Preparing your tax return is an essential process, but it is backward-looking. You are documenting what already happened, when it is often too late to take any actions to improve your tax situation. For many people, this is the only time of the year when they focus on their taxes.

Tax planning happens *during* the year. It is forward-looking and, instead of simply calculating what you owe after the fact, it encourages consideration of “*What moves could we consider right now that might help when tax time comes?*”

Some of these tax planning options, such as Roth conversions, charitable contributions, and retirement account withdrawals, have a deadline of December 31. By the time you start preparing your tax return the following March-April, the opportunity to leverage those options has already closed.

THE ROLES OF A CPA VS A FINANCIAL ADVISOR

When it comes to taxes, financial advisors and CPAs do not do the same thing.

A CPA typically oversees compliance: making sure your return is accurate, filed correctly, and meets IRS requirements. They are essential for the documentation side of taxes but often have little additional interaction with clients other than the preparation of the client’s tax return.

A financial advisor can help with strategy: looking ahead to identify opportunities to improve tax efficiency and offering guidance on specific actions to take. This could include timing considerations for retirement plan distributions, how to optimize retirement plan contributions, evaluating whether a Roth conversion might make sense in a given year, capital gain management or coordinating charitable giving with other financial goals.

Ideally, a financial advisor and a CPA will complement each other: one helps plan for the year ahead while the other ensures that you meet your tax return submission obligations in a timely and accurate manner.

YOU HAVE FILED YOUR TAX RETURN – NOW WHAT?

Shortly after submitting your tax return is the ideal time to scrutinize the return, assess factors in the upcoming year that may affect your tax situation, and build a plan to optimize your tax burden.

Although every taxpayer’s situation will vary, I like to start with these seven items:

1. Create a Year-Over-Year Comparison – at least three years including the most-recent.

This is also a great tool to have as you are preparing your tax return, as it will help you identify any key disparities vs. previous returns and income or expenses that you claimed in the past and may have forgotten about as you gathered information for your current return.

A simple spreadsheet is a great format, and should include Federal return information:

- Adjusted Gross Income
- Taxable Income
- Deduction taken (standard or itemized)
- Tax liability
- Amount of taxes withheld
- Refund or amount owed
- Marginal tax rate See Reference #1
- Effective tax rate See Reference #1

And State return information:

- Taxable Income
- Deduction taken (standard or itemized)
- Tax liability
- Amount of taxes withheld
- Refund or amount owed
- Effective tax rate (many states have a flat income tax rate or no state income tax)

2. Identify One-Time Events

Look for non-recurring items, such as:

- Sale of a home or business
- Sale of investment assets or exercise of Stock options
- Inheritance or large bonus
- Significant one-time medical expenses
- Significant one-time charitable donations

Separate these from your “normal” tax picture so you do not overreact when planning for the current year.

3. Evaluate the Actual Tax Liability vs. your Withholding and Estimated Tax Payments

This initial step will help assess your tax forecasting accuracy and define the need to improve or adjust your tax planning strategy.

Did you get a large refund or owe money?

If you received a large refund, you gave the government an interest-free loan. Consider adjusting your W-4 or reducing your estimated tax payments.

If you owed a lot when you filed your return, you are at risk of owing additional interest and penalties. In this case, you should consider increasing your withholding and/or quarterly estimated tax payments.

The goal is to calculate your withholding and estimated tax payments to yield a small refund or small balance due (I consider <\$1,000 owed or refunded to be a good range).

4. Assess Your Retirement Plan Contribution Efficiency

Check your 401(k), IRA, Roth IRA and HSA contributions and consider:

- Did you maximize contributions, per available cash flow, to tax-advantaged accounts?
- Should you shift some or all of your contributions between pre-tax vs. Roth account types?
- Are you taking advantage of your Employer's matching contributions?

This is one of the highest-impact tax planning areas, both from a current year and long-term perspective.

5. Capital Gains & Investment Tax Impact

How much tax came from dividends and gains related to the sale of investments? Did you have large capital gains distributions or missed tax-loss harvesting opportunities? Were any of your gains related to the sale of Employee Stock Purchase Program (ESPP) shares or Stock Options?

If so, you should consider:

- a. Tax-efficient fund placement (i.e., allocate investments that pay significant dividends and capital gain distributions into tax-advantaged accounts, and leverage tax-efficient investments in your taxable investment accounts). See Reference #2
- b. Using unrealized losses to offset gains in the coming year.
- c. Confirming the cost basis used when calculating the gain on the sale of ESPP shares or Stock Option shares is accurate.

6. Tax Bracket and Rate Analysis

Marginal Tax Bracket – this is the income tax rate you pay on the next dollar earned. Were you close to the next higher or lower bracket?

If so, you should consider these options:

- i. Increase deferred contributions to tax-deferred retirement plans and HSAs.
- ii. Bunch itemized deductions to optimize deductions over a multi-year period. See Reference #3
- iii. Defer income?
- iv. Adjusting your contribution apportionment between Roth and Pre-tax (traditional) retirement plans. If you find yourself in a marginal tax bracket that you believe is higher than you will be in during retirement, pre-tax retirement contributions will be your preferred option.

Effective Tax Rate – since the Federal income tax is a progressive tax system, this value yields the average tax rate you paid and is helpful to understand your overall tax efficiency.

Your Effective tax rate = Tax liability ÷ Taxable income.

Compare this rate for the most-recent year against prior years. Increases in this rate over time indicates growing taxable income and/or fewer deductions; decreases in this rate over time indicates reduced taxable income and/or increased deductions, or the effects of better tax planning. Understanding this rate is especially important when building a budget and estimating your monthly cash flow.

7. Audit Your Deductions & Credits

Review the deductions and tax credits you claimed on last-year's return. Did you miss anything?

Common deductions include:

- i. Mortgage interest
- ii. Student loan interest
- iii. State & local taxes
- iv. Property taxes
- v. Significant medical expenses
- vi. Charitable contributions
- vii. Income from U.S. Government Obligations (not taxed by most states)

Important tax credits include:

- i. Child Tax Credit
- ii. Child and Dependent Care Credit
- iii. Education credits

If your itemized deductions are close to the standard deduction for your filing status, will a deduction “bunching” strategy help reduce your overall tax burden over several years? ^{See} Reference #3

If you realize that you missed certain deductions or credits that you could have claimed, you can assess the effect an amended return will have re: refunded tax payments.

SUMMARY

Your income tax return is one of the most useful tools you have to help assess your current financial situation and identify opportunities to optimize your short-term and long-term tax efficiency. Tax rules and their impact on income and expense planning can be confusing - leverage a financial advisor or tax professional if you need help. Take the time to review your most-recent tax return and assess the items listed above by mid-year, define a set of specific tasks that need to be completed to optimize your tax burden for the current tax year and future years, then revisit this analysis again in November or December to ensure the defined tasks have been completed and to make any necessary adjustments before December 31st.

REFERENCES

The articles below were referenced in preparing this information and are excellent resources to better understand this topic.

1. https://www.eustaceadvisors.com/files/eustace_advisors_article_20231025_the_difference_between_effective_and_marginal_income_tax_rates.pdf.
2. https://www.eustaceadvisors.com/files/ea_research_paper_understanding_mutual_fund_capital_gains.pdf.
3. https://www.eustaceadvisors.com/files/eustace_advisors_research_paper_optimizing_the_effect_of_itemized_deductions.pdf.
4. <https://www.kiplinger.com/taxes/tax-planning/smart-ways-to-use-your-tax-return-for-financial-planning>.

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