Year-End Planning in 2020

Planning Commentary November 2020

EXECUTIVE SUMMARY

The window of opportunity for many tax-saving moves closes on December 31, so it is important to evaluate your tax situation now, while there is still time to affect your bottom line for the 2020 tax year.

INTRODUCTION

As the end of the year approaches, it is time to consider strategies that could help you reduce your 2020 and 2021 income tax bills. Doing a few quick projections will help you estimate your present tax situation and identify any glaring issues you will need to address while there's still time.

Of course, there are other opportunities besides saving income tax. In this month's newsletter, we will address several year-end planning considerations.

OPEN ENROLLMENT FOR MEDICARE HAS BEGUN

You can sign up for Medicare health and drug plans between October 15 and December 7.

Decide if your coverage will meet your needs during 2021. If you like what you had this year and it is still available next year, you do not need to take any action.

HEALTH CARE ENROLLMENT HAS BEGUN

If you obtain your health insurance through the Heath Insurance Marketplace, now is the time to purchase your health insurance for 2021.

This is the one time of year you can change your health insurance coverage or enroll. If you do not act by December 15, you will miss out on coverage for 2021 unless you qualify for a special enrollment period. Plans sold during open enrollment start January 1, 2021.

FEDERAL INCOME TAX BRACKETS

2020

Rate	For Single Individuals	For Married Individuals Filing Joint Returns	For Heads of Households
10%	Up to $9,875	Up to $19,750	Up to $14,100
12%	$9,876 to $40,125	$19,751 to $80,250	$14,101 to $53,700
22%	$40,126 to $85,525	$80,251 to $171,050	$53,701 to $85,500
24%	$85,526 to $163,300	$171,051 to $326,600	$85,501 to $163,300
32%	$163,301 to $207,350	$326,601 to $414,700	$163,301 to $207,350
35%	$207,351 to $518,400	$414,701 to $622,050	$207,351 to $518,400
37%	$518,401 or more	$622,051 or more	$518,401 or more

Source: Internal Revenue Service

2021

Rate	For Unmarried Individuals	For Married Individuals Filing Joint Returns	For Heads of Households
10%	Up to $9,950	Up to $19,900	Up to $14,200
12%	$9,951 to $40,525	$19,901 to $81,050	$14,201 to $54,200
22%	$40,526 to $86,375	$81,051 to $172,750	$54,201 to $86,350
24%	$86,376 to $164,925	$172,751 to $329,850	$86,351 to $164,900
32%	$164,926 to $209,425	$329,851 to $418,850	$164,901 to $209,400
35%	$209,426 to $523,600	$418,851 to $628,300	$209,401 to $523,600
37%	Over $523,600	Over $628,300	Over $523,600

Source: Internal Revenue Service

MAKE CERTAIN YOU ARE WITHOLDING JUST ENOUGH

If you project that you will owe a substantial amount when you file this year's income tax return, ask your employer to increase your federal income tax withholding amounts. If you are making estimated tax payments, there's an added benefit to doing this: Increases to your withholding are generally treated as having been withheld evenly throughout the year. This may help you avoid paying an estimated tax penalty due to under-withholding.

Of course, if you've significantly overpaid your taxes, you can reduce your withholding accordingly, putting money back in your pocket this year instead of waiting for your refund check to come next year.

BE AWARE OF THE ALTERNATIVE MINIMUM TAX

Originally intended to prevent the very rich from using "loopholes" to avoid paying taxes, the alternative minimum tax (AMT) now reaches further into the ranks of middle-income taxpayers.

The AMT rules disallow certain deductions and treat specific items, such as incentive stock options, differently. As a result, AMT liability may be triggered by such items as:

- The standard deduction
- Large deductions for state, local, personal property, and real estate taxes
- Exercising incentive stock options

If it appears you'll be subject to the AMT, you'll need to take a very different planning approach than you would otherwise consider. For example, if you are subject to the AMT in 2020, prepaying 2020 state and local taxes will not help your 2020 tax situation and may hurt your 2021 bottom line.

If you think AMT is going to be a factor, consider talking to a tax professional about your specific tax situation.

REVIEW BUSINESS TAX STRUCTURE

For the closely-held business owner - once again the decision to be taxed as a C Corporation vs. a pass-through entity (S Corp, Partnership, Sole Proprietor) should be reviewed. Both the immediate and long-term impacts of the decision should be carefully considered.

INCOME TIMING STRATEGIES

Defer Income to 2021:

Consider any opportunities you have to defer income to 2021. For example, you may be able to defer a year-end bonus or delay the collection of business debts, rents, and payments for services. Doing so may allow you to postpone paying tax on the income until next year. If there's a chance that you'll be in a lower income tax bracket next year, deferring income could mean paying less tax on the income as well.

To delay income to the following year, you might be able to:

- Defer year-end bonuses
- Defer the sale of capital gain property (or take installment payments rather than a lump-sum payment)
- Postpone receipt of distributions (other than required minimum distributions) from retirement accounts

Accelerate Deductions:

Similarly, consider ways to accelerate deductions into 2020. If you itemize deductions, you might accelerate some deductible expenses, or you might consider making next year's charitable contribution this year instead.

To accelerate deductions into this year:

- Consider paying medical expenses in December rather than January, if doing so will allow you to qualify for the medical expense deduction.
- Prepay deductible interest
  - *Make sure the mortgage payment is made before year-end, and consider prepaying certain other expenses, such as state income tax. (However, do not bother prepaying interest, insurance premiums, or rent on investment property; these prepayments cannot be deducted.)*
- Make deductible alimony payments early
- Make next year's charitable contributions this year
  - *These may be made by check or credit card. Coordinate charitable planning and tax planning by considering the donation of appreciated securities.*
- **Business expenses deductible on Schedule C.** This may be the perfect time for self-employed individuals to upgrade their computers or purchase office furniture. Charges to a credit card qualify if they are made before year-end, even if the credit card balance is not paid until the following year.
- **Contributions to 529 plans.** Taxpayers who take a state tax deduction need to get their contributions in by December. 31.

Accelerate Income to 2020:

Based on President-elect Biden's campaign pledge not to increase taxes on those making less than $400,000, accelerating income is something to consider if you know your 2021 income will exceed that threshold.

Defer Deductions:

If tax rates are expected to increase, the strategy is to push deductions to the following year so that you can offset income that would otherwise be taxed at the higher rate.

If paying an expense or making a charitable contribution is not going to yield a benefit in 2020, waiting until 2021 may make sense to give yourself an increased opportunity for those deductions to save on tax.

Democrats have urged the repeal of the $10,000 cap on itemized deductions for state and local income and property taxes (SALT). If you have a property tax bill that can be paid next year and are wondering if you might hold off the payment, that could be a good idea. If you are over the $10,000 limit for 2020, it is better to have a chance for a deduction in 2021 than none in 2020.

INVESTMENT PLANNING STRATEGIES

Accelerate Gains:

Biden's campaign proposals would significantly increase the capital gains tax for taxpayers with income over $1 million. While details are not clear, the proposal could increase the 20% federal tax rate on long-term capital gains to nearly double at 39.6%.

With this great of a potential increase in the capital gains tax rate in 2021, it may make sense for taxpayers with appreciated assets to consider selling before the end of 2020 to lock in the current more favorable tax rates. However, with control of Congress still up in the air and tax laws uncertain, it is a difficult decision to make.

Defer Unrealized Losses:

Under a Biden tax plan, losses become more valuable. If you believe that capital gains rates could be significantly higher after this year, consider taking those losses in future years.

By deferring sales to 2021, your tax bill could be postponed until April 2022. But if Biden's proposals become law effective to the date of sale, that tax bill could be doubled.

Do Not Let The Tail Wag the Dog:

You should not make investment decisions for tax reasons alone. The underlying economics for any major asset transaction should always be the guiding force. Your main guide should always be the underlying investment decision, especially for regular events like rebalancing your portfolio.

RETIREMENT ACCOUNT PLANNING STRATEGIES

Max Out Your Retirement Accounts:

You can put up to $6,000 into an IRA in tax-year 2020; $7,000 if you are 50 or older. You will have until Tax Day to make a 2020 tax-year contribution. The sooner you contribute, the longer your assets can grow tax-deferred.

Contributions to your 401(k) are automatically deducted from each paycheck. Contributions for tax-year 2020 must be made by the end of the year to count against 2020 income. The 401(k) contribution limit is $19,500 for 2020 and the catch-up limit is $6,500.

We strongly suggest that you contribute the minimum amount necessary to receive your entire employer's match. Do not leave free money on the table.

This Year's RMD Waiver:

If you are 72 (or turned 70½ before January 1, 2020), you are obligated to take a required minimum distribution (RMD) from your IRA. But this year (2020) is an exception.

Thanks to the CARES Act, the RMD waiver applies to everyone with a 401(k), IRA, 403(b), or 457(b) account. Owners of inherited IRAs may suspend RMDs for 2020, too.

If RMDs were already taken, they can be repaid if they are otherwise eligible for rollover. This means any repayment must be made within 60 days and is subject to the once-per-year rollover rule (since the August 31 deadline that relieved these rules has passed).

However, if you are a “qualified individual” who has been impacted by COVID-19, then you don’t need to worry about either the August 31 deadline or the 60-day deadline as you have three years to pay back the amount (up to $100,000).

Qualified Charitable Distribution:

If you are over 70½, you may be eligible to transfer up to $100,000 from your IRA to a charity without paying taxes on the distribution. This is called a qualified charitable distribution or QCD. Moreover, a QCD satisfies the RMD requirement as long as certain rules are met.

Perform ROTH Conversions Before December 31st:

If you have been hesitant about converting traditional IRAs or pretax 401(k) funds to Roth accounts, this may be the perfect time to take action. Even though you would be paying taxes on the conversion now, we are in a low tax environment and it is very possible that taxes will increase in future years, particularly if there is a “blue wave.” In addition, 2020 taxable income for individuals could be lower than in the past as a result of lost income from the pandemic as well as waived RMD’s.

Just keep in mind that recent legislation has eliminated the option to recharacterize a Roth IRA conversion. You no longer get a “mulligan.”

Consider the Need for a Coronavirus-Related Distribution:

Under the CARES Act, individuals under 59½ who are “qualified individuals” can withdraw up to $100,000 of coronavirus related distributions (CRDs) from IRAs and/or company plans if needed. CRDs are not subject to the 10% early distribution penalty, and there is the option to spread the taxable income over a three-year period.

Utilize the Net Unrealized Appreciation Strategy:

The net unrealized appreciation (NUA) can be a lucrative tax-planning tool for individuals with highly appreciated company stock in their 401(k). NUA allows an individual to pay ordinary income tax on the cost basis of the shares (not the total value of the shares) when withdrawn. The difference between the two—referred to as the NUA—is not taxable until the shares are sold (and at favorable long-term capital gains rates).

It is important to remember that the participant’s entire account must essentially be emptied (with a few limited exceptions) within one calendar year. Therefore, if you plan to use this strategy, you need to ensure the lump sum distribution occurs by December 31.

Evaluate 2020 IRA Contributions and Trust Beneficiary Documentation:

Taxpayers who made excess contributions to their IRA for 2020 have the option to remove it, plus the net income attributable, by October 15, 2021, and the 6% excess contribution penalty will not apply.

In regard to beneficiaries, if an IRA owner or retirement plan participant named a trust as a beneficiary and died in 2020, it is important that the trustee provide the required documentation to either the IRA custodian or the plan administrator by October 31, 2021. If the trustee does not submit the paperwork by the deadline, the trust will not meet the “look-through rules,” and trust beneficiaries may lose advantageous tax treatment for distributions from the trust.

ESTATE PLANNING STRATEGIES

Time To Revisit Your Estate Planning?

The end of 2019 saw the SECURE Act, which brought many changes that make updating an estate plan a priority, including new rules for how individuals can leave their retirement accounts to their beneficiaries.

Now in 2020, the pandemic has also put a spotlight on the lack of coordination in estate plans. Coordination gaps can range from not funding a revocable trust and having outdated specific bequests, to the need to review the details of a health care directive and ensure that plans for incapacity address the health care realities we’ve seen under COVID-19.

The high gift and estate tax exemption amount of $11.58 million per person in 2020 ($23.16 million for a married couple) has left many people thinking that they do not need to worry about estate taxes. If the exemption amount decreases, whether under the Biden presidency or through the sunset of the current rules in 2026, more families and individuals will want to consider making gifts for tax purposes. Estate plans may also need to be updated to address transferring assets in ways that consider a lower threshold for tax.

Notably, this reversion of the current estate tax exemption amount back to its pre-TCJA limits ***was already scheduled to occur in 2026*** – *after the Tax Cuts and Jobs Act sunsets* – but the Biden tax plan would accelerate that reversion back to the old limits in 2021 instead.

The current law states that heirs can receive appreciated assets with a step-up in basis to the asset's fair market value at the time of death. Therefore, appreciated assets can be transferred at death without a capital gains tax liability. However, Biden's tax plan also proposes to eliminate the step-up in basis rules which could result in even lower-earners potentially facing a significant and problematic tax bill on inherited assets.

Of course, there are always the standard reasons to update an estate plan for major life events, like marriage, divorce, and the birth of children or grandchildren.

Strategies to Reduce Estate Tax:

Under the current law, married couples can transfer assets of $23.16 million without incurring federal estate tax. Individuals can gift up to this amount without paying any federal gift tax on it during their lifetimes, and any remaining exclusion can be used to offset estate taxes at death.

A structured sale or gifting strategy throughout the owner's lifetime can be a good way to mitigate taxes for the beneficiary should Biden's plan pass. High net worth individuals should consider using as much of their exemption in 2020 as their circumstances allow.

The IRS has stated that there will be no clawback if these exemptions are used now, even if the exemption is later reduced. Therefore, it is important for wealthy individuals to know they must use it now or possibly lose it.

Other strategies that can be considered to deal with a smaller exemption in the long-term can potentially include the use of Grantor Retained Annuity Trusts (GRATs), Charitable Lead Annuity Trusts (CLATs), and sales to Intentionally Defective Grantor Trusts (IDGTs).

Life insurance could see renewed potential as a tool to provide liquidity and/or mitigate the burden of a high tax liability resulting from the inheritance.

FINAL THOUGHTS

While Joe Biden's campaign proposals included several significant tax changes, his presidency appears likely to face a divided Congress that may make it difficult to fully get his agenda passed. Yet, at the same time, the January run-off elections for both Senate seats in Georgia preserve the possibility of a Democrat-controlled Congress, where the Biden tax proposals could more easily be pushed through to law. We await that outcome, and any planning ramifications it may have.

Your personal situation is unique. Reviewing it – especially in light of much uncertainty is important, but making a plan and taking action is what will make the difference. With a historic year coming to an end, these year-end planning strategies could prove to be more critical than ever.

Sincerely,

James Landry, ChFC
Chief Operating Officer,
Director of Planning
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