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Balance sheet

YEAR- END TAX PLANNING

By Timothy J. Gephart, CPA

Year-end tax planning for 2020 takes place during the COVID-19 pandemic, which in addition to its devastating health impact, has widely brought massive unemployment, business closures, and an enormous amount of uncertainty. All of this has made 2020 seem like the year that never ends. New tax rules have been enacted to help mitigate the financial impact of the disease, some of which should be considered as part of this year's planning, most notably the elimination of required retirement plan distributions and liberalized charitable deduction rules.

Major tax changes from recent years generally remain in place, including lower income tax rates, larger standard deductions, limited itemized deductions, elimination of personal exemptions, an increased child tax credit, and a lessened alternative minimum tax (AMT) for individuals; a major corporate tax rate reduction, limits on interest deductions, and generous expensing and depreciation rules for businesses. And non-corporate taxpayers with certain income from pass-through entities may still be entitled to a valuable deduction.

Despite the lack of major year-over-year tax changes, the time-tested approach of deferring income and accelerating deductions to minimize taxes still works for many taxpayers, along with the tactic of "bunching" expenses into this year or the next to get around deduction restrictions. For individuals, deferring income also may help minimize or avoid phase-outs of various tax breaks based on a taxpayer's adjusted gross income (AGI). As always, however, year-end tax planning does not occur in a vacuum. It just takes account of each taxpayer's particular situation and planning goals, with the aim of minimizing taxes to the greatest extent possible. For many taxpayers, it is quite likely that 2020 was a comparatively bad year thanks to COVID-19. Hopefully, you expect to be in a higher tax bracket in 2021. If so, take the opposite approach. Accelerate income into this year (if possible) and postpone deductible expenditures until 2021. That way, more income will be taxed at this year's lower rate instead of next year's higher rate.

Another reminder is to consider using a credit card to pay deductible expenses before the end of the year. When you charge the transaction, it is considered a deductible expense on the date of the charge. Doing so will increase your 2020 deductions even if you do not pay your credit card bill until the year 2021.

Year-end Planning Moves for Individuals

Take Advantage of Generous Standard Deduction Allowances. For 2020, the standard deduction amounts are $12,400 for singles and those who use married filing separate status, $24,800 for married joint filing couples, and $18,650 for heads of household. If your total annual itemizable deductions for 2020 will be close to your standard deduction amount, consider making additional expenditures before year-end to exceed your standard deduction. That will lower this year's tax bill. Next year, you can claim the standard deduction, which will be increased a bit to account for inflation.

The easiest deductible expense to accelerate is included in your house payment due on January 1. Accelerating that payment into this year will give you 13 months' worth of interest in 2020. Mortgage insurance premiums for eligible taxpayers also are deductible in 2020, but will once again be disallowed in 2021 barring extension.

Also, consider state and local income and property taxes that are due early next year. Prepaying those bills before year-end can decrease your 2020 federal income tax bill because your itemized deductions will be that much higher. However, the maximum amount you can deduct for state and local taxes is $10,000 ($5,000 if you use married filing separate status).

Accelerating other expenditures could cause your itemized deductions to exceed your standard deduction in 2020. For example, consider making bigger charitable donations this year and smaller contributions next year to compensate. The CARES Act offers two unique opportunities for charitable minded taxpayers in 2020. Individuals who do not itemize will be allowed an "above the line" deduction of up to $300 in 2020. For those who do itemize, the CARES Act increases the limit on charitable deductions to 100% of the individual's Adjusted Gross Income (AGI) for cash contributions made to public charities in 2020. Note there is no requirement that the contributions be related to COVID-19.

Among the provisions of the Disaster Act set to expire in 2020 is the reduced threshold for the medical expense deduction. You might consider accelerating elective medical procedures, dental work, and vision care. For 2020, medical expenses are deductible to the extent they exceed 7.5% of AGI, but that threshold is set to increase to 10% in 2021.

Traditional IRA Contributions for All. The SECURE Act removed the age restriction on making traditional IRA contributions. Individuals over the age of 70½ who are still working in 2020 are no longer prohibited from contributing to a traditional IRA. However, if you are over age 70½ and considering making a charitable donation directly from your IRA (known as a *Qualified Charitable Distribution* or *QCD*) in the future, making a deductible IRA contribution will affect your ability to exclude future QCDs from your income.

Carefully Manage Investment Gains and Losses in Taxable Accounts. If you hold investments in taxable brokerage firm accounts, consider the tax advantage of selling appreciated securities that have been held for over 12 months. The maximum federal income tax rate on long-term capital gains recognized in 2020 is only 15% for most folks, although it can reach a maximum of 20% at higher income levels. The 3.8% Net Investment Income Tax (NIIT) also can apply at higher income levels.

To the extent you have capital losses that were recognized earlier this year or capital loss carryovers from pre-2020 years, selling winners this year may not result in any tax hit. In particular, sheltering net short-term capital gains with capital losses is a sweet deal because net short-term gains would otherwise be taxed at higher ordinary income rates. Reminder that net capital losses can be used to shelter up to $3,000 of 2020 ordinary income from salaries, bonuses, self-employment income, interest income, royalties, and whatever else ($1,500 if you use married filing separate status). Any excess net capital loss from this year is carried forward to next year and beyond.

Convert Traditional IRAs into Roth Accounts. This may be the perfect time to make that Roth conversion you have been thinking about. The current tax rates are still relatively low compared to a couple of years ago, and they are scheduled to remain that way until 2026. Also, your income may be lower in 2020 due to the financial fallout of COVID-19. On the bright side, that means you are likely in a lower tax bracket than you normally find yourself. Since the CARES Act suspended Required Minimum Distributions (RMDs) for 2020, if you already budgeted to pay tax on your RMD, rolling that distribution to a Roth IRA could be a perfect move. No RMD for 2020 also means that 100% of the distribution can be classified as a rollover. When converting, consider selecting beaten-down stocks or mutual funds which means your rollover distribution will contain more assets. Once in the Roth IRA, the recovery of the value of the assets and ultimate withdrawal will be tax free.

Consider Intrafamily Loans. Interest rates are at a historic low and continue to decrease. This scenario creates an attractive opportunity for those interested in assisting family members financially and transferring assets in a tax-efficient manner. Intrafamily loans, along with proper gift tax planning, may be a smart move.

Year-end Planning Moves for Small Businesses

Net Operating Losses (NOLs). The CARES Act temporarily relaxed many of the NOL limitations that were implemented under the Tax Cuts and Jobs Act (TCJA). If your small business expects a loss in 2020, know that you will be able to carry back 100% of that loss to the prior five tax years. If you had an NOL carried into 2020, you can claim a deduction equal to 100% of your 2020 taxable income.

Establish a Tax-favored Retirement Plan. If your business does not already have a retirement plan, now might be the time to take the plunge. Current retirement plan rules allow for significant deductible contributions. For example, if you are self-employed and set up a SEP-IRA, you can contribute up to 20% of your self-employment earnings, with a maximum contribution of $57,000 for 2020. If you are employed by your own corporation, up to 25% of your salary can be contributed with a maximum contribution of $57,000.

Other small business retirement plan options include the 401(k) plan (which can be set up for just one person), the defined benefit pension plan, and the SIMPLE-IRA. Depending on your circumstances, these other types of plans may allow bigger deductible contributions.

The SECURE Act offers an additional incentive for establishing a retirement plan in 2020. The credit for employers that adopt a new eligible plan is increased from $500 to a maximum of $5,000, and a $500 credit has been added for new small employer plans with an auto-enrollment feature.

Take Advantage of Generous Depreciation Tax Breaks. 100% first-year bonus depreciation is available for qualified new and used property that is acquired and placed in service in calendar-year 2020. That means your business might be able to write off the entire cost of some or all of your 2020 asset additions on this year's return. So, consider making additional acquisitions between now and year-end. Thanks to the CARES Act, Qualified Improvement Property (QIP) is now eligible for bonus depreciation (or can be depreciated over 15 years rather than 39 years). So, consider making additional acquisitions, including QIP acquisitions, between now and year-end.

Cash in on Generous Section 179 Deduction Rules. For qualifying property placed in service in tax years beginning in 2020, the maximum Section 179 deduction is $1.04 million. The Section 179 deduction phase-out threshold amount is $2.59 million.

Watch out for Business Interest Expense Limit. The CARES Act temporarily relaxed the unfavorable TCJA limitation on a taxpayer's deduction for business interest expense. The rules for businesses conducted as partnerships, LLCs treated as partnerships for tax purposes, and S corporations are especially complicated. Fortunately, many businesses are exempt from this limit. We can help you determine if an exemption applies.

Changes affecting business owners of pass-through entities. Effective January 1, 2018, the tax law established a new deduction based on an individual's qualified business income. The law provides that an individual taxpayer generally may deduct 20% of "qualified business income" from a partnership, S corporation, sole proprietorship, or farm, as well as 20% of the aggregate qualified real estate investment trust (REIT) dividends and qualified publicly traded partnership (PTP) income. This deduction is subject to various rules and limitations such as restrictions that can apply at higher income levels and another restriction based on the owner's taxable income.

The above only covers some of the year-end tax planning moves that could potentially benefit you and your business. Please contact us if you have questions or would like us to help you with year-end planning.