2020 Year End Tax Planning

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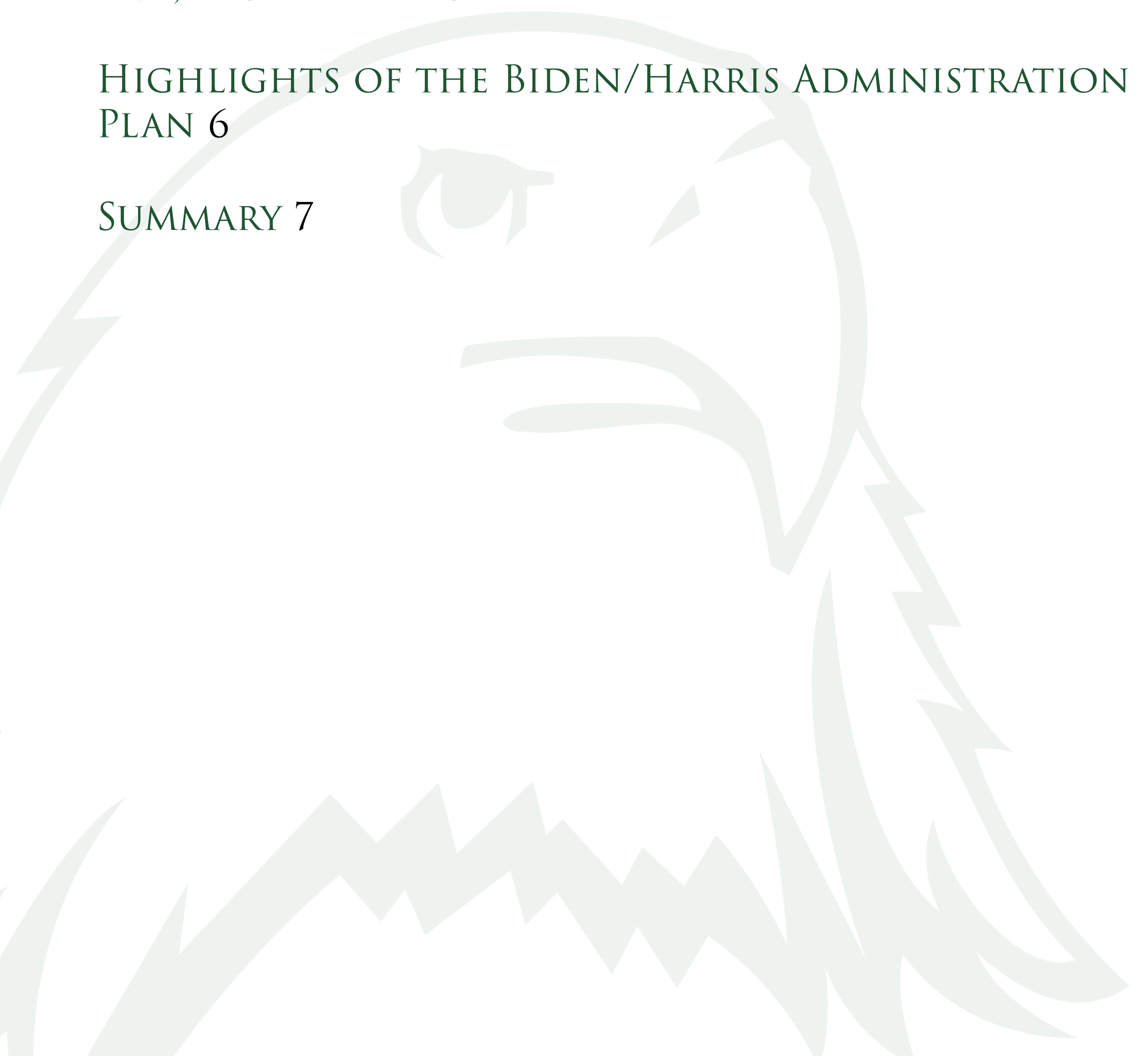

Year End Tax Planning - Overview

As year end approaches, it's a good time to consider engaging in tax planning. Essentially, year end tax planning involves the timing of income and deductions with the objective of eliminating, reducing or deferring tax liability. Unfortunately, in today's changing environment it is not quite that simple. It is important to consider the following when evaluating tax planning strategies:

- The objective should be to achieve your personal financial and/or business goals in the most tax-efficient manner possible.
- Minimizing taxes can potentially enhance overall investment and business returns.
- Although tax planning is most effective when done throughout the year, many tax saving strategies can be identified and implemented as year end approaches.
- New tax legislation routinely presents tax planning opportunities. Recent tax legislation contains provisions that affect subsequent tax years. Therefore, ongoing tax planning is necessary to take advantage of tax saving strategies.
- Effective tax planning requires accurate estimates of taxable income for 2020 and 2021.
- Developing reliable estimates is critical to making planned tax savings.
- Not every tax planning opportunity is appropriate for every person. However, identifying specific planning ideas that work for your profile can potentially reduce your tax liabilities.

Most tax tips, suggestions, and strategies are of little practical help without an understanding of your current tax situation. This is particularly true for year end planning and why it is important to evaluate your current tax situation while there's still time to affect your bottom line for the 2020 tax year. Tax projections will help you estimate your present tax situation and identify any possible issues you'll need to address.

Basic Tax Planning Strategies

<u>Timing is Everything</u>

The last few months of the year may be the time to consider deferring or accelerating income and deductions, taking into consideration the impact on both this year's and next year's taxes.

Delaying Income & Accelerating Deductions

You may be able to defer a year end bonus, defer the sale of capital gain property (or take installment payments rather than a lump-sum payment), or delay the collection of business debts, rents, and payments for services. Doing so may allow you to defer 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 that income as well. Similarly, we can consider strategies to accelerate deductions into 2020. If you itemize deductions, you might accelerate some deductible expenses like medical expenses, qualifying interest, or state and local taxes (for those not exceeding the new $10,000 cap) by making payments before year end. You may also consider making next year's charitable contribution this year instead.

Accelerating Income & Postponing Deductions

What if you'll be in a higher tax bracket in 2021? If you know that you'll be paying taxes at a higher rate in 2021 (say, for example, that an out-of-work spouse will be reentering the workforce in January), you might take the opposite track. Consider whether it makes sense to try to accelerate income into 2020, and to postpone deductible expenses until 2021.

Withholding from Wages

If projected that you will owe a substantial amount when you file this year's income tax return, ask your employer to increase your income tax withholding amounts before the year end. Even though the additional withholding will come from your last few paychecks, it's generally treated as having been withheld evenly throughout the year. This may help you to avoid paying an estimated tax penalty due to under withholding. If your situation is the opposite, where you have significantly overpaid your taxes and estimate you'll be receiving a large refund, you can reduce your withholding accordingly, putting money back in your pocket this year, as opposed to waiting for your tax refund to come in the following year.

IRAs and Retirement Plans - a Key Part of Planning

Make sure that you're taking full advantage of tax-advantaged retirement savings vehicles. Traditional IRAs (assuming that you qualify to make deductible contributions) and employer-sponsored retirement plans such as 401(k) plans allow you to contribute funds pretax, reducing your 2020 taxable income. Contributions you make to a Roth IRA (assuming you meet the income requirements) or a Roth 401(k) aren't deductible, so there's no tax benefit for 2020, but qualified Roth distributions are completely free from federal income tax, making these retirement savings vehicles very appealing. For 2020, you can contribute up to $19,500 to a 401(k) plan ($26,000 if you're age 50 or older), and up to $6,000 to a traditional IRA or Roth IRA ($7,000 if age 50 or older). The window to make 2020 contributions to an employer plan typically closes at the end of the year, while you generally will have until the original due date of your 2020 federal income tax return to make 2020 IRA contributions.

The Secure Act - Overview

- The Setting Every Community Up For Retirement (SECURE) Act became law on Dec. 20, 2019.
- The SECURE Act will make it easier for small business owners to set up "safe harbor" retirement plans that are less expensive and easier to administer.
- Many part-time workers will be eligible to participate in an employer retirement plan.
- The SECURE Act pushes back the age at which retirement plan participants need to take required minimum distributions (RMDs), from 70½ to 72, and allows traditional IRA owners to keep making contributions indefinitely.
- The SECURE Act mandates that most non-spouses inheriting IRAs take distributions that end up emptying the account within 10 years.
- The SECURE Act allows 401(k) plans to offer annuities.

The 2020 Tax Planning Environment

Here are some of the highlights of the Tax Cuts and Jobs Act (TCJA) that took effect in the 2018 tax year:

Individuals

- The number of tax brackets remain the same, but the graduated rates of each bracket have been reduced.
- The standard deduction increased for individuals and couples to $12,400 and $24,800, respectively, for 2020.
- Personal exemptions have been reduced to $0.
- Itemized deductions:
  - » State and property tax deductions are limited to $10,000.
  - » Miscellaneous itemized deductions are eliminated.
  - » Medical expenses are deductible to the extent they exceed 7.5% of income for 2020.
- The child tax credit was doubled from $1,000 to $2,000.
- Other dependent tax credit of $500 was added.
- The Alternative Minimum Tax (AMT) exemption phase-outs have dramatically increased.
- The estate and gift tax exemption was more than doubled to $11,580,000 for individuals and $23,160,000 for married couples for 2020.

Businesses

- Section 199A – This code section created by the TCJA allows individuals to potentially deduct up to 20% of combined qualified business income (QBI) from partnerships, S-corporations, sole proprietorships, trusts, and estates.
- The corporate tax rate for C-corporations was reduced from 35% to 21%. It may be beneficial to change the business entity structure to take advantage of this lower rate.

The New Maryland Entity-Level Tax

In response to the recently imposed federal cap of $10,000 on state and local tax (SALT) deduction, several states (Connecticut, Louisiana, Maryland, New Jersey, Oklahoma, Rhode Island and Wisconsin) have enacted an option to have the passthrough entity (S corporations & partnerships) be taxed on the entity level.

The IRS released a letter on November 9, 2020 announcing proposed regulations clarifying that state and local income taxes imposed on and paid by a partnership or an S corporation on its income will be allowed a deduction on the federal partnership or S corporation (and not being limited).

As a result, state and local income taxes, whether mandatory or elective, will be deductible at the level of the federal partnership or S corporation and not passed through to individual partners or shareholders of the entity who are subject to the SALT deduction limitation that applies to individuals who itemize deductions for federal income tax purposes.

There is still time to plan accordingly and pay in estimated state income taxes on the entity level before year end, thus providing a federal tax deduction on your 2020 partnership or S corporation tax return.

The CARES Act - Overview

Here are some of the highlights of the Coronavirus Aid, Relief, and economic Security (CARES) Act that passed March 27, 2020:

- The CARES Act was passed to provide fast and direct economic assistance for American workers, families, and small businesses - and to preserve jobs for American workers.
- Americans who pay taxes received a one-time direct deposit of up to $1,200, and married couples received $2,400, plus an additional $500 per child. The payments were available for incomes up to $75,000 for individuals and $150,000 for married couples. Credits will be reported and reconciled on the 2020 individual tax return.
- The program provided $250 billion for an extended unemployment insurance program and expanded eligibility and offered workers an additional $600 per week from March through June, on top of what state programs pay.
- The measure allows employers the option to delay the payment of their portion of payroll taxes until 2021 and 2022.
- The bill waives the 10% early withdrawal penalty for distributions up to $100,000 for coronavirus-related purposes, retroactive to January 1, 2020. Withdrawals are still taxed, but taxes are spread over three years, or the taxpayer has a three year period to roll it back over.
- The 401(k) loan limit is increased from $50,000 to $100,000.
- Required Minimum Distributions from IRAs and 401(k) plans (at age 72) are suspended.
- The Tax Cuts and Jobs Act (TCJA) net operating loss rules are modified. The 80% rule is lifted, and losses can now be carried back five years.
- Net operating losses arising in tax years beginning after December 31, 2017, and before January 1, 2021, can now be carried back five years. But this is only good through year end! (As of now, you cannot carry back losses starting next year.)
- All testing and potential vaccines for COVID-19 will be covered at no cost to patients.

Highlights of the Biden/Harris Administration Proposed Tax Plan

The Biden/Harris Administration released their proposed tax plan prior to the November 3, 2020 presidential election. Because the United States Senate will most likely remain in Republican control, it is unknown if the Biden plan will actually become law. Here are a few highlights of Biden's plan, which should be taken into account when planning for taxes in the future.

Highlights of the Biden/Harris Administration Proposed Tax Plan - continued

- The plan would raise taxes on individuals with income above $400,000.
- The top tax rate will increase from 37% to 39.6%.
- Long-term capital gains and qualified dividends will be taxed at ordinary tax rates on income over $1,000,000 and eliminate step-up in basis for capital gains taxation.
- The qualified business income deduction (Section 199A 20% pass through deduction) will be phased out for filers with taxable income above $400,000.
- The plan would impose a 12.4% Social Security payroll tax for wages above $400,000 (to be split between the employer and the employee).
- The plan would temporarily increase the generosity of the Child Tax Credit and Dependent Credit.
- The plan would raise the corporate income tax rate from 21% to 28%.
- The estate and gift tax will be restored to the rate and exemption of 2009 levels (exemption amount reduced).

In Summary

The above highlights some of the key year end tax planning areas for consideration along with changes from the TCJA, CARES, and SECURE Acts. Since all these provisions together are quite complicated, we suggest an analysis be performed using tax software to calculate your approximate 2020 tax liabilities between now and the end of the year.

Please contact our office if you have any specific questions or need further guidance. We appreciate the opportunity to be of service to you.

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