Year-end tax and financial planning considerations

The end of the year provides a time to review your financial plans and see how they should adapt, particularly amidst rapid change.

Federal responses to the COVID-19 pandemic in 2020 produced significant changes that could impact your short- and long-term financial goals and tax strategies. This overview highlights some of the most significant adjustments to interest rates, rules and deadlines and provides ideas to take advantage of these changes. The sections covered comprise planning strategies for individuals, advanced planning strategies and updates for business owners and corporate executives.

PLANNING STRATEGIES FOR INDIVIDUALS

CHANGES THAT AFFECT IRAS AND RETIREMENT PLANS

The rules governing required minimum distributions, or RMDs, began changing in 2019 with the SECURE Act, and further changed with the COVID-19 stimulus package CARES Act in 2020.

Required minimum distributions

- RMDs are waived for 2020.

Under normal rules, the amount not withdrawn under the RMD is penalized at a rate of 50%.

KEY TAKEAWAYS

Starting with the 2017 tax law, closing out 2019 with the SECURE Act and continuing with the 2020 pandemic-era relief efforts, much has changed quickly in the tax and retirement landscape. It's important to be aware of the changes.

The end of the year is a good time to review your financial plans, investments, healthcare savings, retirement strategies and estate plan. It is also a good time to consider your long-term philanthropic goals and other gifting opportunities, like education.

Amid the complexities of the market and tax law in recent years, it's always best to consult with your financial advisor and tax professional before making significant decisions.

- IRA owners who turn 70 1/2 after 2019 can now wait until age 72 to start taking RMDs.

When the CARES Act's temporary RMD waiver ends, those who turned 70 1/2 before 2020 are required to continue following the old rule – for everyone else, RMDs start at age 72.

Contributions

- Payments to graduate or post-doctoral students are treated as income when determining IRA contribution eligibility.
- Payments to graduate or post-doctoral students are treated as compensation for making IRA contributions.

Before the SECURE Act, fellowships, stipends or similar payments to graduate and post-doctoral students were not counted as income when making IRA contributions. Qualifying students can begin saving for retirement sooner.

Inheritance

- Rules tightened on inherited IRAs and workplace-sponsored retirement plans.

The SECURE Act requires most inherited IRAs and workplace retirement accounts to be fully distributed within 10 years of the death of the IRA owner or 401(k) participant. There are exceptions for payouts to surviving spouses, disabled individuals, the chronically ill, minor children until they reach 18 and beneficiaries who are not more than 10 years younger than the account owner. Accounts of owners who died before 2020 are not affected by this change.

Early withdrawals

- Account owners can withdraw up to $100,000 from an eligible retirement plan (ex. 401(k) or 403(b)) without penalty for coronavirus-related needs.

The 10% penalty for withdrawing up to $100,000 from a retirement account early – when the owner is under the age of 59 1/2 – was temporarily waived by the CARES Act when taken for coronavirus-related needs.

Plan owners have three years to pay taxes on the withdrawal or they can pay the account back to undo the tax consequence.

- If you are having or adopting a baby, payouts from IRAs and 401(k)s up to $5,000 are no longer subject to the 10% fine for withdrawals made before age 59 1/2.

This change was included as part of the 2019 SECURE Act.

CHANGES TO HEALTH SAVINGS ACCOUNTS, FLEXIBLE SPENDING ACCOUNTS AND HEALTH REIMBURSEMENT ARRANGEMENTS

Health savings accounts (HSAs), flexible spending accounts (FSAs) and health reimbursement arrangements (HRAs) are efficient, tax-advantaged plans used to pay qualifying medical expenses. This tax advantage can result in meaningful savings on the cost of healthcare expenses. Before COVID-19, the government expanded the allowable uses of the plan. Other changes followed in response to the pandemic.

KNOW THE DIFFERENCES

HSA: A health savings account allows you to set aside pre-tax income for the purpose of qualifying medical care, making it an efficient, avenue for paying for care and insurance cost-sharing, like copays and coinsurance.

FSA: A flexible spending account is an employer-sponsored account that allows you to set aside pre-tax earnings for the purpose of qualifying care. Money set aside must be spent before the end of the year – or within a limited grace period after the start of the new year.

HRA: A health reimbursement arrangement is an employer-funded plan to reimburse employees for medical expenses and insurance premiums. It is funded by the employer, who can then deduct the related expenses.

Starting in 2020, funds from HSAs, FSAs and HRAs can be used to purchase over-the-counter medicines, as well as menstrual care products.

And as part of the relief effort, the IRS announced that anyone with a high-deductible health plan that covers medical expenses related to COVID-19 can contribute to an HSA even before the plan deductibles have been met. Coverage includes diagnostic testing for influenza A and B, norovirus and other coronaviruses, and respiratory syncytial virus – and any items or services required by law to be covered with zero cost sharing. It also included telehealth and other remote care services.

FSAs also saw several notable changes starting in 2020, particularly when the sponsoring employer changes its plan

midyear. If that happens, employers can now allow employees to sign up to or revoke an election to contribute to a health or dependent care FSA. They can also increase or decrease the amount contributed in 2020 to a health or dependent care FSA.

Employers also have the flexibility with their FSAs to extend the grace period through the end of 2020. For example, if the typical grace period for 2019 spending ended in February, the employer now has the option to extend it through Dec. 31, 2020. It's important to note, however, that an employee who had unused portions of their FSA from 2019 and is given an extension through 2020 will not be able to contribute to an HSA through this period.

CHANGES TO EDUCATION INVESTMENT ACCOUNTS

A popular type of tax-advantaged education savings plan, known as a 529, saw its scope expanded in 2017 as part of federal tax legislation. The legislation qualified the use of 529 plans to cover elementary or secondary education enrollment or attendance expenses for public, private or religious schools up to $10,000 per year per beneficiary.

Starting in 2020, 529 plans can also be used to pay for other related post-secondary costs like books, fees, supplies and equipment for certain apprenticeship programs. Further, up to $10,000 (lifetime) can be withdrawn to pay down student loans.

The CARES Act brought another change to the education-finance landscape by allowing employers to pay as much as $5,250 toward an employee's student loans in 2020. This payment is not considered income for federal tax purposes. Other employer-provided, education-related expenses, like reimbursements for tuition, fees and books, must fit below the same $5,250 cap.

OTHER TAX-RELATED CHANGES TO NOTE FOR 2020

A rapid series of tax changes since 2017 may allow you to retroactively amend previous tax returns and receive a refund. Because of the complexity of some of these changes, it may be best to consult with your tax professional about the benefit of pursuing these options. Here, we've listed miscellaneous tax changes, tax extenders and various deduction and credit opportunities that could impact your bottom line.

- Several expired or expiring tax breaks were revived in late 2019, many through 2020. These include deductions for mortgage insurance premiums and college tuition, as well as the $2 million exclusion for forgiven mortgage debt and certain home energy-savings credits. These breaks were effective in 2018, so it may be worth making an amended 2018 return as well to claim those refunds.
- The 2017 tax law decreased the floor for deducting qualifying medical expenses to 7.5% of adjusted gross income for the tax years 2017 and 2018 – a break for all taxpayers. The floor was extended to remain at 7.5% through 2020. You must itemize your deductions to benefit.
- Self-employed workers who couldn't work because of the pandemic can receive a tax credit against the self-employment tax. To claim it, they must meet the requirements that would entitle a regular employee paid sick leave or family leave under the Families First Coronavirus Response Act.
- Adoption credit can be taken on up to $14,300 of qualified expenses, which is up from $14,080 in 2019. The full credit is available for a special-needs adoption, even if qualified expenses are less than that amount. The credit is income limited, and phases out starting at $214,520 adjusted gross income and is no longer available for those with incomes past $254,520. The exclusion for company-paid adoption aid was also increased in 2020 to $14,300 from $14,080.
- The 2017 tax law's adjustment of the so-called "kiddie tax" was repealed. Prior to 2018, unearned income of children age 18 or under, or 24 and under for students, above a certain threshold was taxed at the higher of their tax rate or their parents' tax rate. The law changed the rules to tax unearned income at the ordinary income rate and capital gains rates that apply for trusts. This change had the effect of costing many filers more in taxes, including military families with survivor benefits, therefore it was repealed. With the implementation of the SECURE Act, the pre-2018 rules apply again for 2020, and 2018 and 2019 returns can be amended to follow the pre-2018 rule, as well.
- The residential solar credit dropped four percentage points to 26% for 2020. It will fall again to 22% in 2021 and is then set to end. The same applies for tax breaks for geothermal heat pumps, residential wind turbines and fuel cells.

REGULAR ESTATE PLAN REVIEWS

You should periodically review your estate plan to adjust for events and your personal circumstances. While the risk of contracting COVID-19 remains a possibility, it is always important to make sure documents such as wills, powers of attorney, healthcare directives and living wills are up to date, pandemic or not.

Additionally, the current economic environment, including low interest rates and a high unified tax credit, which pertains to gift, estate and generation-skipping transfer taxes, may allow you to look at your planning documents with fresh eyes.

ADVANCED TAX PLANNING AND STRATEGIES

EXPLORE THE BENEFITS OF TAKING A ROTH CONVERSION

A Roth conversion moves all or part of your traditional pre-tax IRA to a Roth IRA. Roth conversions are used as a tax planning strategy by accelerating income taxes due on the converted amount to create tax-free retirement account growth.* Generally, amounts converted will be subject to ordinary income tax in the year converted. If your traditional IRA has after-tax contributions, any distributions, including distributions as a result of a Roth conversion, will be subject to the pro-rata rule. Some of the benefits include:

- Tax diversification in retirement. Roth IRA distributions are generally tax-free, whereas traditional IRA distributions are taxable.
- A planning opportunity to create tax-free income* for beneficiaries. It may also be used if the beneficiary is, or plans to be, in a higher tax bracket than the IRA owner when the account is received.
- Limits on future RMDs for tax bracket management. A Roth conversion will result in a smaller traditional IRA, which equates to lower RMDs.

Since the income limits on Roth conversions were removed in 2010, higher-income individuals who are not eligible to make a Roth IRA contribution have been able to make an indirect "backdoor Roth contribution" instead by simply contributing to a non-deductible IRA – which can always be done regardless of income – and converting it shortly thereafter.

PORTFOLIO AND TAX PLANNING OPPORTUNITIES

These tax strategies may be particularly apt in light of the market volatility experienced through 2020, depending on your investment portfolio.

Rebalancing

The year produced large gains for a number of stocks, particularly among technology firms and others well-suited for the pandemic economy, but not all sectors were as fortunate. If you've shifted your asset allocations based on this market movement, it's a good time to reflect on those changes to see if they meet your long-term goals and risk tolerance.

Tax-loss harvesting

Selling depreciated assets, and therefore locking in losses, can allow you to update your asset allocations and offset capital gains and regular income this year or in future years as capital loss carryover. Like rebalancing, this allows you to readjust your portfolio to align with your goals and risk tolerance.

Qualified charitable distribution

Recent changes to RMDs did not impact your ability to make a qualified charitable distribution from your retirement plan. With a qualified charitable distribution, an IRA owner or beneficiary older than 70 1/2 can distribute up to $100,000 from an IRA directly to a qualified charity and exclude that distribution from federal income tax. You are not required to itemize deductions to take advantage of this type of distribution, so it may be an effective strategy for those who take the standard deduction.

Consider donating to charities

The COVID-19 relief CARES Act raised the limits on deductions of cash donations from 60% of a filer's adjusted gross income to 100%, when made to a qualified charity. Cash gifts exceeding 100% adjusted gross income in 2020 will carry forward for five years. To take advantage of this change, you must itemize your deductions. This rule is not retroactive; prior years' returns are subject to the earlier limits.

If you intend to make a major philanthropic donation, it may benefit your long-term tax plan to give before the end of 2020. Note, however, that contributions to donor advised funds and private non-operating foundations do not benefit from the raised caps.

* In order for earnings to be tax- and penalty-free, converted funds must be held in the Roth IRA for five years and distributions must occur after age 59 1/2 or as a result of death, disability, or first-time home purchase of $10,000. A separate five-year period applies for each conversion.

Beyond that, the CARES Act added a smaller, easy-to-use provision for charitable giving: an "above the line" deduction of up to $300 in charitable cash contributions available to those who do not itemize deductions.

ANNUAL EXCLUSION AND LIFETIME GIFTS

When valuations are low and volatility is high, it can be advantageous to make annual exclusion gifts with lower-value securities.

EXCLUSION GIFT

Gifts up to $15,000 per beneficiary per year do not count against the lifetime gift tax exemption limit of $11.58 million per person.

Making large gifts with cash or securities allows a taxpayer to remove assets from a taxable estate while retaining more of the estate tax, gift tax and generation-skipping transfer tax exemptions. This can be an efficient wealth transfer strategy. If you're concerned the exemptions will be lowered after the upcoming federal election, you may choose to use more of the $11.58 million exemption sooner rather than later.

The gift and estate tax exclusion amounts are set to sunset after 2025, barring an extension, and are set to return to pre-2018 levels. The IRS has stated it will not recapture these gifts for taxation if the exemption is lowered.

PLANNING STRATEGIES FOR BUSINESSES AND EXECUTIVES

CARES ACT BUSINESS IMPACTS

The COVID-19 relief act brought several implications to business owners that should be considered as you work through your year-end planning. Consult with your tax and legal advisors to determine whether these planning instances are appropriate.

Payroll tax deferral

A key provision of the CARES Act provides employers the ability to delay the payment of employer payroll taxes until Dec. 31, 2021. At that time, half of the payroll tax will be due with the rest due by Dec. 31, 2022. This is intended to try to alleviate the burden on employers who have struggled to make payroll. This also includes self-employed individuals. Businesses that take out paycheck loans may not be eligible for this deferral.

STRATEGIES FOR HIGH-NET-WORTH INDIVIDUALS

High-net-worth individuals with appreciated assets should consider combining giving strategies to maximize gift tax benefits.

- Make larger donations in cash to charities.
- Contribute to a donor advised fund (DAF). DAF gifts are valuable for donating long-term appreciated assets to minimize capital gains and maximize the 30% adjusted gross income charitable deduction limit for appreciated securities.

Using a combination of the strategies would allow you to take full advantage of the increased adjusted gross income deduction limit for gifts and receive tax savings on long-term appreciated assets.

Net operating loss carryback

Businesses will be able to carry back net operating losses (NOLs) again, which were allowed prior to the 2017 Tax Cuts and Jobs Act. The NOL carryback option allows businesses to use the losses against prior year income, which helps to reduce prior year income and claim refunds. The 2017 tax act disallowed the option to use an NOL for prior years and only to be carried forward indefinitely, offsetting income in future years.

The CARES Act allows businesses to use their 2018, 2019 or 2020 NOL to be carried back up to five years, which could provide refunds to some businesses needing cash.

DEDUCTION FOR PASS-THROUGH INCOME

A key threshold on the 20% deductions for pass-through income was increased for 2020. Self-employed people and owners of LLCs, S corporations and other pass-through entities can deduct 20% of their qualified business income, subject to limitations for individuals with taxable incomes in excess of $326,600 for joint filers and $163,300 for others. These increased from $321,400 and $160,700 in 2019, respectively.

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