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2020 Individual Year-End Tax Planning Tips

Year-end planning for 2020 takes place against the backdrop of a global pandemic that has impacted so many individuals. The following is a brief overview of many year-end tax saving strategies, incorporating the implications of the pandemic and how they will affect individuals. Some are straightforward, while others require more analysis and review to tailor them to your particular tax and financial situation. Please call on us to help you sort through the options and implement strategies that make sense for you and your situation.

Individual income tax rates

Your so-called "*ordinary"* income (e.g., compensation, interest income, most retirement income, and net short-term capital gains) is taxed at increasing tax rates that apply to different ranges of income. In 2020, there are seven *ordinary* income tax brackets as follows: 10%, 12%, 22%, 24%, 32%, 35%, and 37%. Although all tax brackets have been retained, the income limits for each have been adjusted for inflation. Determining the overall tax impact on a particular individual or family in 2020 will be similar to 2019 in many ways due to the changes that were put in place by the New Law, such as: an increase in the standard deduction, **loss of personal and dependency exemptions,** the elimination or limitation of certain itemized deductions, increases in the child tax credit, higher income phase-outs for the child credit, a new credit for certain qualifying dependents, and others. Additional tax implications will be present for the 2020 filing season in connection with the CARES Act and related stimulus payments.

Minimize Tax on Capital Gains

Generally, when you sell stock or mutual fund shares, the shares you purchased first are considered sold first. That's usually good news since it's often beneficial to qualify for the lower long-term capital gain rate by selling shares that have been held more than one year. However, there may be situations where you're better off selling shares other than those that have been held the longest. For example, the newer shares may have a higher cost-basis (because you paid a higher price for them) which would result in a smaller taxable gain or even a loss that can be netted against the gain. When you want to sell shares other than those you purchased first, you must properly notify your broker as to the specific shares you want sold.

Realize Losses on Stock

You can take losses on stock while substantially preserving your investment position. There are several ways this can be done. For example, you can sell the original holding, and then buy back the same securities at least 31 days later. Or, if you own a fund (such as an index fund), you can sell it, and buy a similar fund right away while still claiming the loss. This works great with index funds, because as long as you buy a fund of the same index, it contains all the same securities.

Maximize Certain "Above the Line" Deductions

"Above-the-line" deductions reduce both your "adjusted gross income" (AGI) and your modified adjusted gross income (MAGI), while "itemized" deductions (i.e., below-the-line deductions) do not reduce either AGI or MAGI. Deductions that reduce your AGI (or MAGI) can potentially generate multiple tax benefits, for example by:

1) Reducing your taxable income and allowing you to be taxed in a lower tax bracket;
2) Freeing up deductions (and tax credits) that phase out as your AGI (or MAGI) increases (e.g., child credit; certain IRA contributions; certain education credits; adoption credit, etc.); and
3) Reducing your MAGI below the income thresholds for the 3.8% Net Investment Income Tax (i.e., 3.8 % NIIT only applies if MAGI exceeds $250,000 if married filing jointly; $200,000 if single).

Many of the popular "above-the-line" deductions were retained under the *New Law,* such as deductions for IRA and Health Savings Account (HSA) contributions, health insurance premiums for self-employed individuals, qualified student loan interest, and business expenses for a self-employed individual.

Tax-Free Qualifying Transfers From IRAs To Charities Retained

The popular rule allowing taxpayers who have reached age 70½ to make a tax-free transfer of up to $100,000 from their IRAs directly to a qualified charity has been retained. You must be at least 70 1/2 on the date of the gift. If you turn 70 1/2 on December 5th, for example, you must wait until that day or later to make the transfer and get the break.

If married, you and your spouse can each give up to $100,000 yearly from IRAs directly to charity. Qualified charitable distributions (QCD) can also count as your required minimum distributions, but they are not taxable and they are not added to your adjusted gross income, so they won't trigger a Medicare premium surcharge. Since this tax break effectively allows a qualifying taxpayer to exclude all or a portion of their otherwise taxable RMDs from taxable income, it has the same effect as allowing an "above-the-line" deduction for the charitable contribution.

The money from the IRA must go directly to a charitable organization. Transfers to a donor-advised fund, charitable gift annuity, charitable remainder trust or any other life-income or split-interest gift arrangement aren't treated as a QCD.

If you are currently required to take Required Minimum Distributions (RMD) from your IRA accounts and historically have made charitable contributions, you may want to consider making a Qualified Charitable Distribution (QCD) from your RMD.

Required Minimum Distribution Planning

Generally, taxpayers age 70 1/2 and older are required to take withdrawals from their retirement accounts by year-end or pay a fine equal to 50% of the shortfall. Similar requirements also exist for beneficiaries of inherited IRA accounts regardless of their age. The CARES Act passed in March of this year included a number of measures designed to stimulate the economy. One of these provisions allows these individuals to forego taking any Required Minimum Distributions (RMDs) for tax year 2020. RMDs are based on the value of accounts at the end of the previous year. Most accounts suffered significant losses in 2020, which could have made the required withdrawals a much larger percentage of retiree's accounts. The provisions within the new law attempt to enable retirees to keep the money in their accounts and potentially recoup some of the market losses as the economy turns back around.

The waiver applies to anyone subject to RMDs, regardless of age. This includes original account holders over age 70 1/2, original account owners who turned 70 1/2 in 2019 but have not yet taken their distribution, and inherited-IRA beneficiaries of any age.

Despite the temporary relief granted under the CARES Act, it's important that retirees have a distribution strategy for RMDs to avoid having them become a "ticking time bomb" - bumping you into a higher tax bracket.

The basic retirement withdrawal sequence is generally recommended as follows:

1. Taxable accounts, such as brokerage accounts
2. Required minimum distributions (RMDs) from Tax-deferred retirement accounts (Traditional IRAs, 401(k)s, 403(b)s or 457 plans)
3. Tax-exempt retirement accounts (Roth IRAs and Roth 401(k) plans)

There are various strategies for paying taxes on your RMD. For instance, you could pay estimated tax payments or you could simply increase withholdings on one or more of your retirement plan distributions. For many individuals we suggest they increase their withholdings rather than paying quarterly estimates. First of all, you may no longer need to remember to make the payments and you can time when the payment is made. Our recommendation in many cases is to have the withholdings done as late in the year as possible so the funds are available for investment throughout the year. Withholdings are treated as paid in evenly throughout the year by the IRS, so there is no penalty for making the payments via year-end withholdings.

Consider a Health Savings Account (HSA)

HSA's allow you to pay for certain medical expenses on a pretax basis. If you meet certain requirements for 2020, your HSA contribution can be up to $7,100 for family coverage and $3,550 for single coverage (plus an additional $1,000 if you're 55 or older) and can be made regardless of your income level. These contributions are 100% tax deductible above-the-line, so you benefit even if you don't itemize or are subject to high-income itemized deduction phase outs. You can then take tax-free withdrawals to pay uninsured medical expenses. A provision of the CARES Act now allows withdrawals to be made tax-free to pay for the cost of over the counter medications, retroactive to January 1 of this year. Withdrawals not used for medical expenses are taxable and if taken before age 65 are subject to a 20% penalty tax. After age 65, withdrawals are taxed as ordinary income. In the meantime, they can build tax-free. It is also important to note that 2020 deductible HSA contributions can be contributed until April 15, 2021.

Consider Contributing to 401(k) Plans that Accept Roth 401(k) Contributions

Earnings on funds in a Roth IRA grow tax-free (as opposed to merely tax-deferred as in a traditional IRA or 401(k) plan). However, higher-income taxpayers are ineligible to make Roth IRA contributions. Currently, taxpayers covered by a 401(k) plan will be able to designate some or all of their 401(k) contributions as Roth 401(k) contributions. Thus, they will be able to take advantage of tax-free growth in their retirement account just like those who are able to contribute to Roth IRAs. The 2019 contribution limit for Roth 401(k) plans is $19,500 ($26,000 if age 50 or older), which is much higher than the $6,000 ($7,000 if age 50 or older) limit on Roth IRA contributions.

One Caution: Unlike "regular" 401(k) contributions, contributions that you designate as Roth 401(k) contributions are taxed to you the year they're made. But the benefit of tax-free earnings and distributions on those contributions (provided they're held in the plan for a certain amount of time) will often outweigh the tax-deferral on a regular 401(k) plan contribution. This is especially true if your tax rate is higher when you withdraw the money from your 401(k) plan than it was when the funds were contributed (which could be the case given the current federal deficit picture).

Convert Traditional IRA to Roth IRA

If your traditional IRA has dropped in value or you expect to pay higher federal income tax rates in future years, you might want to consider converting all or part of your traditional IRA balance into a Roth IRA. Here's why: If you convert, it will trigger a current tax hit on the amount you convert. But, with your traditional IRA balance at a depressed level (and possibly your overall income too) the tax hit will be less. After the conversion, all the income and gains that accumulate in your Roth IRA, and all withdrawals after you reach age 59 1/2, will be totally free of any federal taxes—assuming you meet the tax-free withdrawal rules. In contrast, future withdrawals from a traditional IRA could be hit with tax rates that are higher than today's rates.

Of course, conversion is not a no-brainer. You have to be satisfied that paying the upfront conversion tax bill makes sense in your circumstances. In particular, converting a big account all at once could push you into higher tax brackets, which would not be good. You must also make assumptions about future tax rates, how long you will leave the account untouched, the rate of return earned on your Roth IRA investments, and so forth. If the Roth IRA conversion idea intrigues you, please contact us for a full analysis of the tax consequences.

Retirement Account Contributions

You may want to consider increasing contributions to your Roth, traditional IRA, or other retirement savings account. The table below provides information on the contribution limits for 2020**,** which can be made through April 15, 2021.

Maximum IRA contribution (traditional or Roth): $6,000	Maximum IRA contribution if age 50+: $7,000
Maximum 401(k) salary-deferral contribution: $19,500	Maximum 401(k) contribution if age 50+: $26,000
Maximum 403(b) salary-deferral contribution: $19,500	Maximum 403(b) contribution if age 50+: $26,000
Maximum SEP account contribution: $57,000	Maximum profit-sharing account contribution: $57,000
Maximum SIMPLE IRA salary -deferral contribution: $13,500	Maximum SIMPLE contribution if age 50+: $16,500

Increased Standard Deduction

In 2020, the Standard Deduction increases to the following levels: Joint Return - $24,800; Single - $12,400; and Head of Household - $18,650. The increased standard deduction, combined with changes to Itemized Deductions, may make it difficult to itemize going forward. You may want to consider bunching two years of anticipated charitable contributions into one year. Alternatively, you can consider setting up a Donor Advised Fund (see below) into which you can make tax deductible charitable contributions and can direct the funds to your specific charities over the course of time.

Consider Year-End Donations

You can accelerate contributions planned for 2021 into 2020, but you must charge them or mail the checks by December 31st to ensure a write-off. Try to make your donations with appreciated stock that you've owned for over a year. This way, you can deduct the full value and never pay capital gains tax on the appreciation.

Check Your Health Flexible Spending Account (FSA)

You must clean it out by December 31 if your employer hasn't implemented the 2 1/2-month grace period or the $500 carryover rule. Otherwise, you will forfeit any money left in your account. Also, consider electing to contribute to a health FSA for 2021. You can contribute up to $2,750 to your employer's health FSA to cover out-of-pocket medical expenses. Amounts contributed to an FSA escape federal income tax as well as payroll taxes.

Charitable Giving with a Donor-Advised Fund

As a result of the *New Law*, it might be beneficial to consider managing your charitable giving with a Donor-Advised Fund (DAF).

With a DAF you establish a private account with an organization that sponsors donor-advised funds. The organization itself is a public charity, such as a community foundation, a university, or perhaps the charitable arm of a brokerage or mutual fund company. You then contribute cash or other assets to your account, which is invested so it may grow over time. Because the sponsoring organization is a public charity, you can take an immediate tax deduction for the cash and assets you contribute, even before a single grant is made. When you are ready to make grants, you simply advise the sponsoring organization of your choices. Although the sponsoring organization has legal control over your account and the authority to decline your grant recommendations, it will generally follow them as long as they adhere to the organization's guidelines.

You can donate all of the funds in your account quickly, or you can space out your grants over time. The flexibility to make tax-deductible contributions now yet award the grants later can be very attractive in certain situations. Let's say, for instance, that you want to make a charitable gift by the end of the year for tax reasons, but you do not have enough time to choose the charities you want to benefit from your gift. A DAF allows you the time to make thoughtful choices while meeting your immediate financial goal of a tax deduction. Or let's say that you want to establish a tradition of giving in your family. A DAF provides the structure to invest your gift and make grants on an ongoing basis, perhaps involving members of your family in the selection of grant recipients.

Tax Benefits of a Donor-Advised Fund (DAF)

Using a DAF offers several tax advantages.

- You can claim a charitable tax deduction for the contributions you make to your DAF.
- Contributions of appreciated stock or other assets that you held for longer than one year avoid capital gains tax and can generally be deducted at their fair market value.
- Your contributions avoid estate taxes because they are no longer part of your estate.
- Your contributions can grow tax-free within a DAF account, potentially increasing the amount available to support your favorite charities and causes.

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As with charitable gifts in general, you must itemize deductions on your tax return to claim a deduction for your contributions. Keep in mind that the deduction for charitable contributions is subject to limits based on your adjusted gross income (AGI). The limits, however, are more generous for contributing to a DAF than to a private non-operating foundation. As a result, donations to a DAF may result in a larger tax deduction.

Enhanced Child Credit

For 2020, the child credit for each “Qualifying Child” who had not reached age 17 by the end of the tax year remains at $2,000. The income phase-out thresholds also remain unchanged and begin phasing out as the individual’s modified adjusted gross income (MAGI) exceeds $400,000 on a joint return and $200,000 for all other returns.
The refundable portion of the child credit also remains at $1,400. A “refundable” credit generally means to the extent the credit exceeds the taxes you would otherwise owe with your individual income tax return without the credit, the IRS will refund the excess to you.

Family Tax Credit

The family tax credit created under the *New Law* remains unchanged for 2020. It is a non-refundable credit of $500 for each person the taxpayer could have claimed as a dependent under prior law but who is not a Qualifying Child (e.g., a “Qualifying Relative” as defined under prior law). This $500 credit is added to any other child tax credits and the total credits begin phasing out once a taxpayer’s MAGI exceeds $400,000 on a joint return or $200,000 for singles.

Maximize contributions to and distributions from Section 529 Education Savings Plans

Vermont allows a 10% tax credit on up to $2,500 contributed to a beneficiary’s 529 plan. For a married couple the credit is maxed at $500. These contributions have to be made before December 31st. If your child is currently in college and you will need to make a tuition payment, you can make the contribution for the VT credit and then pay the college expenses from the 529 Plan. You should also review your Qualified Education Expenses as compared to 529 distributions. If you are otherwise eligible to take the federal American Opportunity Tax Credit, you will want to make sure that you have $4,000 of Qualified Education Expenses per child that are not covered by 529 Plan distributions to take advantage of the credit.
If you have funds in a non-Vermont 529 plan, transfers from these plans to the Vermont Higher Education Investment Plan (VHEIP) are eligible for the Vermont Tax credit. Rollovers from another state’s qualified tuition plan into the VHEIP are eligible for the income tax credit to the extent the contributions made to the plan (does not include earnings) and provided the funds remain in the VHEIP for the remainder of the taxable year in which the funds were rolled into the VHEIP.

Be Generous

Make gifts sheltered by the annual gift tax exclusion, such as educational, medical, or political gifts, before year-end to lessen gift and estate taxes. The exclusion applies to gifts of up to $15,000 in 2020 ($30,000 for married couples) made to each of an unlimited number of individuals, but you cannot carry over unused exclusions from one year to the next. In order to qualify you must give the funds directly, and you do not get an income tax deduction for gifts to relatives. Any unused amount is gone forever. You can’t give extra next year to make up for it. Annual gifts over the exclusion amount will trigger filing of a gift tax return for the year. But no gift tax will be due unless your total lifetime gifts exceed $11,700,000.

Conclusion. This newsletter is intended to give you just a few ideas to get you thinking about planning for 2020**.** Copper Leaf Financial develops a customized wealth management (financial) plan designed to integrate every aspect of your financial life. This is "true wealth management" - a holistic approach that goes beyond just investment advice. Our affiliated full service CPA firm, Davis & Hodgdon Associates, enables us to tightly integrate individual and business owner’s wealth management with comprehensive tax advice so that all recommendations can factor in the tax consequences.

Call us today at (802) 878-2731 to schedule a strategy session and begin building your road map to financial success.

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