



2020
2021



TAX PLANNING GUIDE

Year-round
strategies to
make the tax
laws work
for you



PLANNED FINANCIAL
services

Your LIFE. Your MONEY. Your WAY.®

440.740.0130 | www.PlannedFinancial.com

7000 Fitzwater Road, Suite 300 | Cleveland, OH 44141

Investment advice offered through Planned Financial Services, a Registered Investment Advisor.

This information is not intended to be a substitute for specific individualized tax advice. We suggest that you discuss your specific tax issues with a qualified tax advisor.

Tax planning in unprecedented times



It has become a cliché in 2020, but what word other than “unprecedented” can be used to describe the events we’ve experienced this year? During such times, tax planning is far from top of mind. But it’s still important. Smart tax planning can soften the impact of an uncertain economy and provide much-needed relief to owners of struggling businesses.

To take advantage of all available breaks, you need to be aware of some major changes under this year’s Coronavirus Aid, Relief and Economic Security (CARES) Act and last year’s Setting Every Community Up for Retirement Enhancement (SECURE) Act. You also can’t forget about the massive Tax Cuts and Jobs Act (TCJA) that generally went into effect two years ago but still impacts tax planning. Plus, it’s possible that there could be more tax law changes before year end — or that the potential for changes next year could affect 2020 planning.

This guide provides an overview of some of the most significant tax law changes going into effect this year and other key tax provisions you need to be aware of. It offers a variety of strategies for minimizing your taxes in the current tax environment. Use it to work closely with your tax advisor to identify the best strategies for your particular situation. He or she also can keep you apprised of any new tax law developments that might affect you.

Contents

| | |
|-----------------------------|----|
| Income & Deductions..... | 2 |
| Executive Compensation..... | 6 |
| Investing | 8 |
| Real Estate | 12 |
| Business Ownership | 14 |
| Charitable Giving..... | 16 |
| Family & Education..... | 18 |
| Retirement | 20 |
| Estate Planning | 22 |
| Tax Rates..... | 24 |

Control the timing of income and deductions to your tax advantage



Tax rates on “ordinary income” are higher than those that apply to much of your investment income. Ordinary income generally includes salary, income from self-employment or business activities, interest, and distributions from tax-deferred retirement accounts. Some of it may also be subject to payroll tax, or you may have to pay the alternative minimum tax (AMT), under which different tax rates apply. This is why careful planning for ordinary income and deductible expenses continues to be important.

Timing income and expenses

Smart timing of income and expenses can reduce your tax liability, and poor timing can unnecessarily increase it. When you don’t expect to be subject to the AMT (see page 3) in the current year or the next year, deferring income to the next year and accelerating deductible expenses into the current year may be a good idea. Why? Because it will defer tax, which usually is beneficial.

But when you expect to be in a higher tax bracket next year — or you expect tax rates to rise — the opposite approach may be beneficial: Accelerating income will allow more income to be taxed at your current year’s lower rate. And deferring expenses will make the deductions more valuable, because deductions save more tax when you’re subject to a higher tax rate.

Whatever the reason behind your desire to time income and expenses, you may be able to control the timing of these income items:

- ▲ Bonuses,
- ▲ Consulting or other self-employment income,

- ▲ U.S. Treasury bill income, and
- ▲ Retirement plan distributions, to the extent they won’t be subject to early-withdrawal penalties and aren’t required. (See page 20.)

Some *expenses* with potentially controllable timing are mortgage interest, investment interest expense and charitable contributions.

Impact of the TCJA on timing strategies

The TCJA has made timing income and deductions more challenging because some strategies that taxpayers used to implement no longer are making sense. Here’s a look and some significant changes that have affected deductions:

Reduced deduction for state and local tax. Property tax used to be a popular expense to time. But with the TCJA’s limit on the state and local tax deduction, property tax timing will likely provide little, if any, benefit for higher-income taxpayers. (See Case Study 1 at right.) If you reside in a state with no, or low, income tax, this change might be less relevant. But keep in mind that deducting sales tax instead of income tax may be beneficial, especially if you purchased a major item, such as a car or boat.

Suspension of miscellaneous itemized deductions subject to the 2% floor.

This deduction for expenses such as certain professional fees, investment expenses and unreimbursed employee business expenses is suspended through 2025. While this eliminates the home office deduction for employees who work from home (even if your employer has required it during the pandemic), if you’re self-employed, you may still be able to deduct home office expenses. (See page 12.)

More-restricted personal casualty and theft loss deduction. Through 2025, this itemized deduction is suspended except if the loss was due to an event officially declared a disaster by the President.

Increased standard deduction. The TCJA nearly doubled the standard deduction. While many higher-income taxpayers will still benefit from itemizing, some — such as those in low-tax states, who don’t have mortgages or who aren’t charitably inclined — may now save more tax by claiming the standard deduction. (See Chart 1 for the 2020 standard deduction amounts.)

Tax-advantaged saving for health care

If medical expenses not paid via tax-advantaged accounts or reimbursable by insurance exceed a certain

CHART 1 2020 standard deduction

| Filing status | Standard deduction ¹ |
|-----------------------------|---------------------------------|
| Singles and separate filers | \$12,400 |
| Heads of households | \$18,650 |
| Joint filers | \$24,800 |

¹ Taxpayers age 65 or older or blind can claim an additional standard deduction: \$1,300 if married, \$1,650 if unmarried.

CASE
STUDY 1

Factor state and local tax deduction limits into timing strategies

Last year, Justin earned a promotion along with a significant salary increase and bonus, and his state income tax liability increased accordingly. When he filed his 2019 tax return, he was surprised to find that he could no longer deduct all of his state and local income and property taxes. This meant that prepaying his 2019 property tax bill due in early 2020 hadn't helped him. He'd always done his income taxes himself, but he decided it was time to consult a tax professional.

She told Justin that, through 2025, under the TCJA, his entire itemized deduction for state and local taxes — including property tax and either income or sales tax — is limited to \$10,000 (\$5,000 for married taxpayers filing separately). The downside of Justin's raise and bonus was that his 2019 state and local tax liability exceeded \$10,000, so a portion of this liability was no longer deductible.

The tax advisor went on to explain that the limit significantly impacts higher-income taxpayers with large state and local income tax and/or large property tax bills. She advised that Justin take this into account in his income and deduction timing strategies going forward.



percentage of your adjusted gross income (AGI), you can claim an itemized deduction for the amount exceeding that “floor.” This floor can be difficult for higher-income taxpayers to exceed.

The TCJA had reduced the floor from 10% to 7.5% for 2017 and 2018, and last year the 7.5% floor was extended to 2019 and 2020. But it will return to 10% for 2021 unless Congress extends the lower floor again. (Check with your tax advisor for the latest information.)

Eligible expenses may include health insurance premiums, long-term-care insurance premiums (limits apply), medical and dental services, and prescription drugs. Mileage driven for health care purposes also can be deducted — at 17 cents per mile for 2020.

Consider bunching elective medical procedures (and any other services and purchases whose timing you can control without negatively affecting your or your family's health) into alternating years if it would help you exceed the applicable floor and you'd have enough total itemized deductions to benefit from itemizing.

If one spouse has high medical expenses and a relatively lower AGI, filing separately may allow that spouse to exceed the AGI floor and deduct some medical expenses that wouldn't be deductible if the couple filed jointly. **Warning:** Because the AMT exemption for separate returns is considerably lower than the exemption for joint returns, filing separately to exceed the floor could trigger the AMT.

You may be able to save taxes without having to worry about the medical expense deduction floor by contributing to one of these accounts:

HSA. If you're covered by a qualified high deductible health plan, you can contribute pretax income to an employer-sponsored Health Savings Account — or make deductible contributions to an HSA you set up yourself — up to \$3,550 for self-only coverage and \$7,100 for family coverage for 2020 (plus \$1,000 if you're age 55 or older). HSAs can bear interest or be invested, growing tax-deferred similar to an IRA. Withdrawals for qualified medical expenses are tax-free, and you can carry over a balance from year to year.

FSA. You can redirect pretax income to an employer-sponsored Flexible Spending Account up to an employer-determined limit — not to exceed \$2,750 in 2020. The plan pays or reimburses you for qualified medical expenses. What you don't use by the plan year's end, you generally lose — though your plan might allow you to roll over up to \$550 to 2021. Or it might give you a 2½-month grace period to incur expenses to use up the previous year's contribution. In response to the COVID-19 crisis, the IRS has temporarily made FSAs a little more flexible. Contact your employer for details. If you have an HSA, your FSA is limited to funding certain permitted expenses.

Smaller AMT threat

The top AMT rate is 28%, compared to the top regular ordinary-income tax rate of 37%. But the AMT rate typically applies to a higher taxable income base. You must pay the AMT if your AMT liability exceeds your regular tax liability.

The TCJA substantially increases the AMT exemptions through 2025. (See Chart 8 on page 24.) This means fewer taxpayers will have to pay the AMT. In addition, deductions used to calculate regular tax that aren't allowed under the AMT can trigger AMT liability, and there aren't as many differences between what's deductible for AMT purposes and regular tax purposes. (See Chart 2 on page 4.) This also reduces AMT risk. However, AMT will remain a threat for some higher-income taxpayers.

So before timing your income and expenses, determine whether you're already likely to be subject to the AMT — or whether the actions you're considering might trigger it. In addition to deduction differences, some income items might trigger or increase AMT liability:

- ▲ Long-term capital gains and qualified dividend income,
- ▲ Accelerated depreciation adjustments and related gain or loss differences when assets are sold, and
- ▲ Tax-exempt interest on certain private-activity municipal bonds. (For an exception, see the warning on page 11.)

Finally, in certain situations exercising incentive stock options (ISOs) can trigger significant AMT liability. (See the warning at the top of page 7.)

Avoiding or reducing AMT

With proper planning, you may be able to avoid the AMT, reduce its impact or even take advantage of its lower maximum rate:

If you could be subject to the AMT *this year* ... consider accelerating income into this year, which may allow you to benefit from the lower maximum AMT rate. And deferring expenses you can't deduct for AMT purposes may allow you to preserve those deductions (but watch out for the annual limit on the state and local tax deduction). If you also defer expenses you *can* deduct for AMT purposes, the deductions may become more valuable because of the higher maximum regular tax rate. Finally, carefully consider the tax consequences of exercising ISOs.

If you could be subject to the AMT *next year* ... consider taking the opposite approach. For instance, defer income to next year, because you'll likely pay a relatively lower AMT rate. Also, before year end consider selling any private-activity municipal bonds whose interest could be subject to the AMT.

Also be aware that, in certain circumstances, you may be entitled to an AMT credit.

Payroll taxes

In addition to income tax, you must pay Social Security and Medicare taxes on earned income, such as salary and bonuses. The 12.4% Social Security tax applies only up to the Social Security wage base of \$137,700 for 2020. All earned income is subject to the 2.9% Medicare tax. Both taxes are split equally between the employee and the employer.

Also, an Aug. 8 presidential memorandum offers a deferral of the employee share of Social Security taxes, but those earning \$4,000 or

CHART 2 What itemized deductions are also deductible for AMT purposes?

| Expense | Regular tax | AMT | For more information |
|---|-------------|-----|--|
| State and local income tax | ■ | | See "Impact of the TCJA on timing strategies" on page 2. |
| Property tax | ■ | | See "Home-related deductions" on page 12. |
| Mortgage interest | ■ | ■ | See "Home-related deductions" on page 12. |
| Interest on home equity debt used to improve your principal residence or second residence | ■ | ■ | See "Home-related deductions" on page 12. |
| Investment interest | ■ | ■ | See Case Study 5 on page 11. |
| Medical expenses | ■ | ■ | See "Tax-advantaged saving for health care" on page 2. |
| Charitable contributions | ■ | ■ | See page 16. |

more per biweekly pay period aren't eligible. As of this writing, there are many open questions about the deferral. Contact your tax advisor for the latest information.

Self-employment taxes

If you're self-employed, you pay both the employee and employer portions of payroll taxes on your self-employment income. The employer portion (6.2% for Social Security tax and 1.45% for Medicare tax) is deductible above the line. You also may be eligible for some COVID-19 payroll tax relief. (See "What's new!" at right.)

As a self-employed taxpayer, you may benefit from other above-the-line deductions as well. You can deduct 100% of health insurance costs for yourself, your spouse and your dependents, up to your net self-employment income. You also can deduct contributions to a retirement plan and, if you're eligible, an HSA for yourself. And you might be able to deduct home office expenses. (See page 12.) Above-the-line deductions are particularly valuable because they reduce your AGI and, depending on the specific deduction, your modified AGI (MAGI), which are the triggers for certain additional taxes and the phaseouts of many tax breaks.

Additional 0.9% Medicare tax

Another payroll tax that higher-income taxpayers must be aware of is the additional 0.9% Medicare tax. It applies to FICA wages and net self-employment income exceeding \$200,000 per year (\$250,000 if married filing jointly and \$125,000 if married filing separately).

If your wages or self-employment income varies significantly from year to year or you're nearing the threshold for triggering the additional Medicare tax, income timing strategies may help you avoid or minimize it. For example, if you're an employee, perhaps you can time when you receive a bonus or exercise stock options. If you're self-employed, you may have flexibility on when you purchase new equipment or invoice customers. If you're an S corporation shareholder-employee, you might save tax by adjusting how much you receive as salary vs. distributions. (See "Owner-employees" at right.)

Also consider the withholding rules. Employers must withhold the additional tax beginning in the pay period when wages exceed \$200,000 for the calendar year — without regard to an employee's filing status or income from other sources. So your employer might withhold the tax even if you aren't liable for it — or it might *not* withhold the tax even though you *are* liable for it.

If you *don't* owe the tax but your employer *is* withholding it, you can claim a credit on your 2020 income tax return. If you *do* owe the tax but your employer *isn't* withholding it, consider filing a W-4 form to request additional income tax withholding, which can be used to cover the shortfall and avoid interest and penalties. Or you can make estimated tax payments.

Owner-employees

There are special considerations if you're a business owner who also works in the business, depending on its structure:

Partnerships and limited liability companies. Generally, all trade or business income that flows through to you for income tax purposes is subject to self-employment taxes — even if

the income isn't distributed to you. But such income may not be subject to self-employment taxes if you're a limited partner or the LLC member equivalent. Check with your tax advisor on whether the additional 0.9% Medicare tax on earned income or the 3.8% NIIT (see page 11) will apply.

S corporations. Only income you receive as salary is subject to payroll taxes and, if applicable, the 0.9% Medicare tax. To reduce these taxes, you may want to keep your salary relatively — but not unreasonably — low and increase the income that is taxed to you through your Schedule K-1 by virtue of your share of the earnings from the business. That income isn't subject to the corporate level tax or the 0.9% Medicare tax and, typically, is not subject to the 3.8% NIIT.

C corporations. Only income you receive as salary is subject to payroll taxes and, if applicable, the 0.9% Medicare tax. Nonetheless, you may prefer to take more income as salary (which is deductible at the corporate level) as opposed to dividends (which aren't deductible at the corporate level yet are still taxed at the shareholder level and could be subject to the 3.8% NIIT) if the overall tax paid by both the corporation and you would be less.

Warning: The IRS scrutinizes corporate payments to shareholder-employees for possible misclassification, so tread carefully.

Estimated payments and withholding

You can be subject to penalties if you don't pay enough tax during the year through estimated tax payments and withholding. Here are some strategies to help avoid underpayment penalties:

Know the minimum payment rules.

For you to avoid penalties, your estimated payments and withholding must equal at least 90% of your tax liability for 2020 or 110% of your 2019 tax (100% if your 2019 AGI was \$150,000 or less or, if married filing separately, \$75,000 or less).

Use the annualized income installment method. This method often benefits taxpayers who have large variability in income from month to month due to bonuses, investment gains and losses, or seasonal income (at least if it's skewed toward the end of the year). Annualizing computes the tax due based on income, gains, losses and deductions through each estimated tax period.

Estimate your tax liability and increase withholding. If you determine you've underpaid, consider having the tax shortfall withheld from your salary or year end bonus by Dec. 31. Because withholding is considered to have been paid ratably throughout the year, this is often a better strategy than making up the difference with an increased quarterly tax payment, which may still leave you exposed to penalties for earlier quarters. ■

WHAT'S
NEW!

COVID-19 payroll tax relief for the self-employed



To help the self-employed — and employers — during the COVID-19 crisis, the CARES Act allows the payment of the employer share (6.2% of wages) of the Social Security payroll tax to be deferred. Taxpayers can pay the tax over the next two years, with the first half due by Dec. 31, 2021, and the second half due by Dec. 31, 2022. Be aware that, as of this writing, it appears that the deferral of the employee share of Social Security taxes noted under "Payroll taxes" at left *isn't* available to the self-employed. Check with your tax advisor for the latest information.

If you have employees, additional payroll tax breaks may be available to you:

Payroll tax credit. Under the CARES Act, this credit is generally available to employers whose operations have been fully or partially suspended because of a COVID-19-related governmental shutdown order or whose gross receipts have dropped more than 50% compared to the same quarter in the previous year. The credit equals 50% of up to \$10,000 in compensation, including health care benefits, paid to an eligible employee after March 12, 2020, through Dec. 31, 2020.

Paid leave credit. The Families First Coronavirus Response Act generally requires employers with fewer than 500 employees to provide paid leave in certain COVID-19-related situations. Covered employers generally can take a federal payroll tax credit for 100% of the qualified sick and family leave wages they pay each quarter, up to \$511 per day for leave taken for the employee's own illness or quarantine and \$200 for leaves taken to care for others.

Additional rules and limits apply to these breaks, and it's possible they could be expanded or extended by the time you're reading this or that additional relief for employers could become available. Check with your tax advisor for the latest information.

Smart tax planning for your exec comp package is critical



Compensation may take several forms, including salary, fringe benefits and bonuses. If you're an executive or other key employee, you might receive stock-based compensation, such as restricted stock, restricted stock units (RSUs) or stock options (either incentive or nonqualified). Nonqualified deferred compensation (NQDC) may also be included in your exec comp package. The tax consequences of these types of compensation can be complex — subject to ordinary income, capital gains, payroll and other taxes. So smart tax planning is critical.

Restricted stock

Restricted stock is stock your employer grants to you subject to a substantial risk of forfeiture. Income recognition is normally deferred until the stock is no longer subject to that risk (that is, it's vested) or you sell it. When the restriction lapses, you pay taxes on the stock's fair market value (FMV) at your ordinary-income rate. (The FMV will be considered FICA income, so it could trigger or increase your exposure to the additional 0.9% Medicare tax. See page 4.)

But you can instead make a Section 83(b) election to recognize ordinary income when you receive the stock. This election, which you must make within 30 days after receiving the stock, allows you to convert potential future appreciation from ordinary income to long-term capital gains income and defer it until the stock is sold.

The election can be beneficial if the income at the grant date is negligible or the stock is likely to appreciate significantly before income would otherwise be recognized. And with ordinary-income rates now especially low under the TCJA, it might be a good time to recognize income.

There are some potential disadvantages of a Sec. 83(b) election, however. First, prepaying tax in the current year could push you into a higher income tax bracket and trigger or increase your exposure to the additional 0.9% Medicare tax. But if your company is in the earlier stages of development, the income recognized may be relatively small.

Second, any taxes you pay because of the election can't be refunded if you eventually forfeit the stock or sell it at a decreased value. However, you'd have a capital loss in those situations.

Third, when you sell the shares, any gain will be included in net investment income and could trigger or increase your liability for the 3.8% NIIT. (See page 11.)

See Case Study 2 for additional information, and work with your tax advisor to map out whether the Sec. 83(b) election is appropriate for your situation.

RSUs

RSUs are contractual rights to receive stock, or its cash value, after the award has vested. Unlike restricted stock, RSUs aren't eligible for the Sec. 83(b) election. So there's no opportunity to convert ordinary income into capital gains.

But they do offer a limited ability to defer income taxes: Unlike restricted stock, which becomes taxable immediately upon vesting, RSUs aren't taxable until the employee actually receives the stock. So rather than having the stock delivered immediately upon vesting, you may be able to arrange with your employer to delay delivery.

Such a delay will defer income tax and may allow you to reduce or avoid exposure to the additional 0.9% Medicare tax (because the RSUs are treated as FICA income). However, any income deferral must satisfy the strict requirements of Internal Revenue Code Section 409A. Also keep in mind that it might be better to recognize income now because of the currently low tax rates.

Incentive stock options

ISOs allow you to buy company stock in the future (but before a set expiration date) at a fixed price equal to or greater than the stock's FMV at the date of the grant. Thus, ISOs don't provide a benefit until the stock appreciates in value. If it does, you can buy shares at a price *below* what they're then trading for, provided you're eligible to exercise the options.

ISOs receive tax-favored treatment but must comply with many rules. Here are the key tax consequences:

- ▲ You owe no tax when ISOs are granted.
- ▲ You owe no regular income tax when you exercise the ISOs.
- ▲ If you sell the stock *after* holding the shares at least one year from the exercise date and two years from the grant date, you pay tax on the sale at your long-term capital gains rate. You also may owe the NIIT.
- ▲ If you sell the stock *before* long-term capital gains treatment applies, a "disqualifying disposition" occurs and any gain is taxed as compensation at ordinary-income rates. (Disqualified dispositions aren't, however, subject to FICA and Medicare tax, including the additional 0.9% Medicare tax.)

Warning: If you don't sell the stock in the year of exercise, a tax "preference" item is created for the difference between the stock's FMV and the exercise price (the "bargain element") that can trigger the AMT. A future AMT credit, however, should mitigate this AMT hit. Plus, you may now be at lower AMT risk because of the higher AMT exemption and exemption phaseout range under the TCJA. (See Chart 8 on page 24.) Consult your tax advisor because the rules are complex.

If you've received ISOs, plan carefully when to exercise them and whether to immediately sell shares received from an exercise or hold them. Waiting to exercise ISOs until just before the expiration date (when the stock value may be the highest, assuming the stock is appreciating) and holding on to the stock long enough to garner long-term capital gains treatment often is beneficial. But there's also market risk to consider. Plus, acting earlier can be advantageous in several situations:

- ▲ Exercise early to start the holding period so you can sell and receive long-term capital gains treatment sooner.
- ▲ Exercise when the bargain element is small or when the market price is close to bottoming out to reduce or eliminate AMT liability.
- ▲ Exercise annually so you can buy only the number of shares that will achieve a breakeven point between the AMT and regular tax and thereby incur no additional tax.
- ▲ Sell in a disqualifying disposition and pay the higher ordinary-income rate to avoid the AMT on potentially disappearing appreciation.

On the negative side, exercising early accelerates the need for funds to buy the stock, exposes you to a loss if the shares' value drops below your exercise cost, and may create a tax cost if the preference item from the exercise generates an AMT liability.

The timing of ISO exercises also could positively or negatively affect your liability for the higher ordinary-income tax rates, the 20% long-term capital

gains rate and the NIIT. See Case Study 2 for additional information and, with your tax advisor, evaluate the risks and crunch the numbers to determine the best strategy for you.

Nonqualified stock options

The tax treatment of NQSOs is different from the tax treatment of ISOs: NQSOs create compensation income (taxed at ordinary-income rates) on the bargain element when exercised (regardless of whether the stock is held or sold immediately), but they don't create an AMT preference item.

You may need to make estimated tax payments or increase withholding to fully cover the tax on the exercise. Keep in mind that an exercise could trigger or increase exposure to top tax rates, the additional 0.9% Medicare tax and the NIIT.

NQDC plans

These plans pay executives in the future for services to be currently performed. They differ from qualified plans, such as 401(k)s, in several ways. For example, unlike 401(k) plans, NQDC plans can

favor highly compensated employees, but plan funding isn't protected from the employer's creditors. (For more on 401(k)s, see page 20.)

One important NQDC tax issue is that payroll taxes (see page 4) are generally due once services have been performed and there's no longer a substantial risk of forfeiture — even though compensation may not be paid or recognized for income tax purposes until much later. So your employer may withhold your portion of the payroll taxes from your salary or ask you to write a check for the liability. Or it may pay your portion, in which case you'll have additional taxable income. **Warning:** The additional 0.9% Medicare tax could also apply.

Keep in mind that the rules for NQDC plans are tighter than they once were, and the penalties for noncompliance can be severe: You could be taxed on plan benefits at the time of vesting, and a 20% penalty and potential interest charges also could apply. So check with your employer to make sure it's addressing any compliance issues. ■

CASE STUDY 2

Some stock-based compensation may qualify for TCJA tax deferral



Mario was about to receive some stock-based compensation from his employer, so he contacted his tax advisor to find out what the tax consequences would be. His advisor explained that the tax treatment would depend on the type of stock-based compensation. For example, Mario might be able to take advantage of the Section 83(b) election. (See "Restricted stock" at left.) Or he might be eligible for a tax break under the TCJA.

The TCJA break allows for the deferral of tax on stock-based compensation in certain circumstances. Generally, it gives taxpayers the opportunity to match the taxation of restricted stock and stock options with the timing of the sale of the stock. It's intended for situations in which there is no ready market for the sale of the stock.

The availability of the deferral opportunity is limited, however. It generally will apply only if at least 80% of full-time employees are covered by the stock-based compensation plan.

Uncertainty further complicates tax planning for investments



Tax treatment of investments varies dramatically based on factors such as type of investment, type of income it produces, how long you've held it and whether any special limitations or breaks apply. On top of that, economic uncertainty has made tax planning for investments especially challenging this year.

And there are many additional factors to evaluate before deciding whether to sell or hold an investment, such as investment goals, time horizon, risk tolerance, factors related to the investment itself, fees and charges that apply to buying and selling securities, and your need for cash. But taxes are still important to consider.

Capital gains tax and timing

Although time, not timing, is generally the key to long-term investment success, timing can have a dramatic impact on the tax consequences of investment activities. Your marginal long-term capital gains rate can be as much as 20 percentage points lower than your ordinary-income tax rate.

The long-term capital gains rate applies to investments held for more than 12 months. The applicable rate depends on your income level and the type of asset you've sold. (See Chart 3.)

Because of TCJA-related changes to the brackets, through 2025, the top long-term gains rate of 20% kicks in before the top ordinary-income rate does. (See Chart 8 on page 24.) Higher rates still apply to certain types of assets. (See Chart 3.)

Holding on to an investment until you've owned it more than one year may help substantially cut tax on any gain. Keeping it even longer can also make tax sense.

Being tax-smart with losses

Losses aren't truly losses until they're realized — that is, generally until you sell the investment for less than what you paid for it. So while it's distressing to see an account statement that shows a large loss, the loss won't affect your current tax situation as long as you still own the investment.

Realized capital losses are netted against realized capital gains to determine capital gains tax liability. If net losses exceed net gains, you can deduct only \$3,000 (\$1,500 for married taxpayers filing separately) of losses per year

against ordinary income (such as wages, self-employment and business income, interest, dividends, and taxable retirement plan distributions). But you can carry forward excess losses until death.

If you don't have enough gains to absorb losses, you could be left with losses in excess of the annual ordinary-income deduction limit. So think twice before selling an investment at a loss. After all, if you hold on to the investment, it may recover the lost value. In fact, a buy-and-hold strategy works well for many long-term investors because it can minimize the effects of market volatility.

CHART 3 What's the maximum 2020 capital gains tax rate?

| Type of gain | Rate ¹ |
|--|-------------------------------------|
| Short-term (assets held 12 months or less) | Taxpayer's ordinary-income tax rate |
| Long-term (assets held more than 12 months) | 15% |
| Some key exceptions | |
| Long-term gain of certain higher-income taxpayers | 20% ² |
| Most long-term gain that would be taxed at 10% or 12% based on the taxpayer's ordinary-income rate | 0% |
| Long-term gain on collectibles, such as artwork and antiques | 28% |
| Long-term gain attributable to certain recapture of prior depreciation on real property | 25% |
| Gain on qualified small business (QSB) stock held more than 5 years | |
| ■ Acquired before Feb. 18, 2009 | 14% ³ |
| ■ Acquired on or after Feb. 18, 2009, and before Sept. 28, 2010 | 7% ⁴ |
| ■ Acquired on or after Sept. 28, 2010 | 0% |

¹ In addition, the 3.8% net investment income tax (NIIT) applies to net investment income to the extent that modified adjusted gross income (MAGI) exceeds \$200,000 (singles and heads of households), \$250,000 (married filing jointly) or \$125,000 (married filing separately).

² The 20% rate applies only to those with taxable income exceeding \$441,450 (singles), \$469,050 (heads of households), \$496,600 (joint filers), or \$248,300 (separate filers).

³ Effective rate based on a 50% exclusion from a 28% rate.

⁴ Effective rate based on a 75% exclusion from a 28% rate.

CASE STUDY 3**Use capital losses to absorb unrecognized gains**

Marisa's year-to-date net realized losses are \$53,000. Her portfolio includes \$100,000 of stock that she paid only \$50,000 for. Marisa has been thinking about selling it to diversify her portfolio and because year-to-date the stock had dropped from \$130,000 to \$100,000 in value and she's not confident it will recover.

But she's been concerned about the capital gains tax.

Her tax advisor suggests that now might be a good time to sell the stock because her \$50,000 gain would essentially be tax-free: The gain would absorb \$50,000 of losses, leaving Marisa with a \$3,000 net loss, the maximum that she could use to offset ordinary income.



Of course, an investment might continue to lose value. That's one reason why tax considerations shouldn't be the primary driver of investment decisions. If you're ready to divest yourself of a poorly performing stock because, for example, you don't think its performance will improve or your investment objective or risk tolerance has changed, don't hesitate solely for tax reasons.

Plus, building up losses for future use could be beneficial. This may be especially true if you have a large investment portfolio, real estate holdings or a closely held business that might generate substantial future gains, or if tax rates increase.

Finally, remember that capital gains distributions from mutual funds can also absorb capital losses.

Wash sale rule

If you want to achieve a tax loss with minimal change in your portfolio's asset allocation, consider the wash sale rule. It prevents you from taking a loss on a security if you buy a substantially identical security (or an option to buy such a security) within 30 days before or after you sell the security that created the loss. You can recognize the loss only when you sell the replacement security.

Fortunately, there are ways to avoid triggering the wash sale rule and still achieve your goals. For example, you can:

- ▲ Sell the security and immediately buy securities of a different company in the same industry or shares in a mutual fund that holds securities much like the ones you sold,
- ▲ Sell the security and wait 31 days to repurchase the same security, or
- ▲ Before selling the security, purchase additional shares of that security equal to the number you want to sell at a loss, and then wait 31 days to sell the original portion.

Alternatively, you can do a bond swap, where you sell a bond, take a loss and then immediately buy another bond of similar quality and duration from a different issuer. Generally, the wash sale rule doesn't apply because the bonds aren't considered substantially identical. Thus, you can achieve a tax loss with virtually no change in economic position.

Warning: You can't avoid the wash sale rule by selling stock at a loss in a taxable account and purchasing the same stock within 30 days in a tax-advantaged retirement account.

Mutual funds

Investing in mutual funds is an easy way to diversify your portfolio. But beware of the tax pitfalls.

First, mutual funds with high turnover rates can create income that's taxed at ordinary-income rates. Choosing funds that provide primarily long-term gains can save you more tax dollars because of the lower long-term rates.

Second, earnings on mutual funds are typically reinvested. Unless you or your investment advisor increases your basis accordingly, you may report more gain than required when you sell the fund. Brokerage firms are required to track (and report to the IRS) your cost basis in mutual funds acquired during the tax year.

Third, buying equity mutual fund shares late in the year can be costly taxwise. Such funds often declare a large capital gains distribution at year end, which is a taxable event. If you own the shares on the distribution's record date, you'll receive and be taxed on the full distribution amount even if it includes significant gains realized by the fund before you owned the shares. And you'll pay tax on those gains in the current year — even if you reinvest the distribution.

Small business stock

By purchasing stock in certain small businesses, you can diversify your portfolio. You also may enjoy preferential tax treatment:

Conversion of capital loss to ordinary loss. If you sell qualifying Section 1244 small business stock at a loss, you can treat up to \$50,000 (\$100,000, if married filing jointly) as an ordinary, rather than a capital, loss — regardless of your holding period. This means you can use it to offset ordinary income, reducing your tax by as much as 37% of this portion of the loss. Sec. 1244 applies only if total capital invested isn't more than \$1 million.

Tax-free gain rollovers. If within 60 days of selling qualified small business (QSB) stock you buy other QSB stock

CASE
STUDY 4

How to qualify for the 0% capital gains rate



Faced with a long-term capital gains tax rate of 23.8% (20% for the top tax bracket, plus the 3.8% NIIT), Michael and Jennifer decide to give some appreciated stock to their adult son, Ian. Just out of college and making only enough from his entry-level job to leave him with \$25,000 in taxable income, Ian falls into the 12% ordinary-income tax bracket and the 0% long-term capital gains bracket.

However, the 0% rate applies only to the extent that capital gains “fill up” the gap between Ian’s taxable income and the top end of the 0% bracket. For 2020, the 0% bracket for singles tops out at \$40,000 (just \$125 less than the top of the 12% ordinary-income bracket). So if Ian sells the stock his parents transferred to him and his gains are \$15,000, the entire amount will qualify for the 0% rate. The sale will be tax-free vs. the \$3,570 Michael and Jennifer would have owed had they sold the stock themselves.

Warning: If Ian had been subject to the “kiddie tax” (see page 18), the results would have been quite different. It’s also important to consider any gift tax consequences before transferring stock. (See page 22.)

with the proceeds, you can defer the tax on your gain until you dispose of the new stock. The rolled-over gain reduces your basis in the new stock. For determining long-term capital gains treatment, the new stock’s holding period includes the holding period of the stock you sold. To be a QSB, a business must be engaged in an active trade or business and must not have assets that exceed \$50 million, among other requirements.

Exclusion of gain. Generally, taxpayers selling QSB stock are allowed to exclude up to 100% of their gain if they’ve held the stock for more than five years. But, depending on the acquisition date, the exclusion may be less: The exclusion is 75% for stock acquired on or after Feb. 18, 2009, and before Sept. 28, 2010, and 50% for stock acquired before Feb. 18, 2009.

When the exclusion is less than 100%, the taxable portion of any QSB gain will be subject to the lesser of your ordinary-income rate or 28%, rather than the normal long-term gains rate. (See Chart 3 on page 8.) Thus, if the 28% rate and the 50% exclusion apply, the effective rate on the QSB gain will be 14% ($28\% \times 50\%$).

Keep in mind that all three of these tax benefits are subject to additional requirements and limits. Consult your tax and financial advisors to be sure an investment in small business stock is right for you.

Passive activities

If you’ve invested in a trade or business in which you don’t materially participate and where income or loss flows through to your tax return, remember the passive activity rules. Why? Passive activity *income* may be subject to the 3.8% NIIT (see page 11), and passive activity *losses* generally are deductible only against income from other passive activities. You can carry forward disallowed losses to the following year, subject to the same limits.

To avoid passive activity treatment, you must “materially participate” in the activity, which typically means you must participate in the trade or business more than 500 hours during the year or demonstrate that your involvement constitutes substantially all of the participation in the activity. But there are other ways to meet the material participation test. Plus, there are special rules that apply to real estate. (See page 13.) To help ensure your hours

claim will be able to withstand IRS scrutiny, carefully track and document your time. Contemporaneous record-keeping is better than records that are created after the fact.

If you don’t pass the material participation test, consider:

Increasing your involvement. If you can exceed 500 hours, the activity no longer will be subject to passive activity rules.

Grouping activities. You may be able to group certain activities together to be treated as one activity for tax purposes and exceed the 500-hour threshold. But the rules are complex, and there are potential downsides to consider.

Looking at other activities. If you have passive losses, one option is to limit your participation in another activity that’s generating income, so that you don’t meet the 500-hour test. Another is to invest in an additional income-producing trade or business that will be passive to you. Under both strategies, you’ll have passive income that can absorb some or all of your passive losses.

Disposing of the activity. This generally allows you to deduct all passive losses — including any loss on disposition (subject to basis and capital loss limitations). But, again, the rules are complex.

Even if you do pass the material participation test, be aware that your loss deduction might be affected by the TCJA’s rules for deducting business losses. (See “What’s new!” on page 14.)

Income investments

Qualified dividends are taxed at the favorable long-term capital gains tax rate rather than at your higher ordinary-income tax rate. Interest income, however, generally is taxed at ordinary-income rates.

So stocks that pay qualified dividends may be more attractive taxwise than other income investments, such as CDs and taxable bonds. But there are exceptions.

Some dividends, for example, are subject to ordinary-income rates. These include certain dividends from:

- ▲ Real estate investment trusts (REITs),
- ▲ Regulated investment companies (RICs),
- ▲ Money market mutual funds, and
- ▲ Certain foreign investments.

The tax treatment of bond income varies. For example:

- ▲ Corporate bond interest is fully taxable for federal *and* state purposes.

- ▲ Bonds (except U.S. savings bonds) with original issue discount (OID) build up “interest” as they rise toward maturity. You’re generally considered to earn a portion of that interest annually — even though the bonds don’t pay this interest annually — and you must pay tax on it.

- ▲ Interest on U.S. government bonds is taxable on federal returns but exempt by federal law on state and local returns.

- ▲ Interest on state and local government bonds is excludable on federal returns. If the bonds were issued in your home state, interest also may be excludable on your state return, depending on the state.

The fact that a bond is exempt from federal tax doesn’t necessarily make it a better choice than a comparable taxable bond. Municipal bonds, for example, typically offer lower yields than comparable corporate bonds. To make a fair comparison, you need to calculate the tax-equivalent yield — which incorporates tax savings into the municipal bond’s yield — using this formula:

$$\text{Tax-equivalent yield} = \text{actual yield} / (1 - \text{your marginal tax rate}).$$

But you also need to consider factors such as risk and how well each bond will help achieve your overall investment goals.

Warning: Tax-exempt interest from private-activity municipal bonds can trigger or increase AMT liability. However, any income from tax-exempt bonds issued in 2009 and 2010 (along with 2009 and 2010 re-fundings of bonds issued after Dec. 31, 2003, and before Jan. 1, 2009) is excluded from the AMT. And AMT is less of a risk for most taxpayers now. (See page 3.)

3.8% NIIT

Taxpayers with modified adjusted gross income (MAGI) over \$200,000 (\$250,000 if married filing jointly and \$125,000 if married filing separately) may owe the net investment income tax (NIIT) on top of whatever other tax they owe on their investment income. The NIIT equals 3.8% of the lesser of net investment income or the amount by which MAGI exceeds the applicable threshold.

Net investment income can include capital gains, dividends, interest, passive business income, rental income and other investment-related income. But it *doesn’t* include business or self-rental income from an active trade or business.

Many of the strategies that can help you save or defer income tax on your investments can also help you avoid or defer NIIT liability. And because the threshold for the NIIT is based on MAGI, strategies that reduce your MAGI — such as making retirement plan contributions (see page 20) — could also help you avoid or reduce NIIT liability. ■

CASE STUDY 5

Can you deduct investment interest expense?

Frank borrowed to make some investments this year, and he was wondering if the interest would be deductible. So he consulted his tax advisor.

She told him that investment interest expense — interest on debt used to buy assets held for investment, such as margin debt used to buy securities — generally is deductible for both regular tax and alternative minimum tax (see page 3) purposes. But special rules apply.

First, Frank’s investment interest expense deduction would be limited to his net investment income, which, for the purposes of this deduction, generally includes taxable interest, nonqualified dividends and net short-term capital gains (but not long-term capital gains), reduced by other investment expenses. Any disallowed interest expense is carried forward, and Frank can deduct it in a later year against net investment income.

If his interest expense exceeds his net investment income, Frank may elect to treat all or a portion of his net long-term capital gains or qualified dividends as investment income in order to deduct more of his investment interest expense. But if he does, that portion of the long-term capital gain or dividend will be taxed at ordinary-income rates.

Frank’s advisor also explained that payments a short seller makes to the stock lender in lieu of dividends may be deductible as investment interest expense. But interest on debt used to buy securities that pay tax-exempt income, such as municipal bonds, isn’t deductible. Finally, she told Frank to keep in mind that passive interest expense — interest on debt incurred to fund a passive activity — becomes part of his overall passive activity income or loss, subject to limitations. (See page 10.)



Make the most of tax breaks for your home and other real estate



There are many ways you can maximize the tax benefits associated with owning a principal residence, vacation home or rental property. The TCJA has limited certain breaks, but the CARES Act provides some relief. Tax planning is also important if you'd like to sell your home or other real estate this year.

Home-related deductions

Consider these itemized deductions in your tax planning:

Property tax deduction. Under the TCJA, through 2025, the property tax deduction is subject to a \$10,000 limit (\$5,000 if you're married filing separately) on combined deductions for state and local taxes (SALT). (See page 2 for more details.) Higher-income taxpayers owning valuable homes in high-property-tax locations have seen a huge drop in the federal tax benefit they receive from their property tax payments.

Mortgage interest deduction. You generally can deduct interest on mortgage debt incurred to purchase, build or improve your principal residence and a second residence. Points paid related to your principal residence also may be deductible. Through 2025, the TCJA reduces the mortgage debt limit from \$1 million to \$750,000 for debt incurred after Dec. 15, 2017 (\$500,000 and \$375,000, respectively, for separate filers), with some limited exceptions.

Home equity debt interest deduction. Through 2025, the TCJA effectively limits the home equity interest deduction to debt that would qualify for the home mortgage interest deduction. (Under pre-TCJA law, interest was deductible on up to \$100,000 of home equity debt used for any purpose, such as to pay off credit card debt or to buy a car.)

Home office deduction. Under the TCJA, *employees* can no longer deduct home office expenses, because of the suspension of miscellaneous deductions subject to the 2% of adjusted gross income (AGI) floor. (See page 2.) But the self-employed can still claim the deduction, as long as their home office is their principal place of business (or used substantially and regularly to conduct business) and that's the only use of the space.

They can deduct from their self-employment income a portion of their mortgage interest, property taxes, insurance, utilities and certain other expenses, and the depreciation allocable to the space. Or they can use the simplified method for calculating the deduction — \$5 per square foot for up to 300 square feet. Although taxpayers using this method won't be able to

depreciate the portion of their home that's used as an office, they can claim mortgage interest, property taxes and casualty losses as itemized deductions to the extent otherwise allowable, without needing to apportion them between personal and business use of the home.

Home rental rules

If you rent out all or a portion of your principal residence or second home for less than 15 days, you don't have to report the income. But expenses directly associated with the rental, such as advertising and cleaning, won't be deductible.

If you rent out your principal residence or second home for 15 days or more, you'll have to report the income. But you may be entitled to deduct some or all of your rental expenses — such as utilities, repairs, insurance and depreciation. Exactly what you can deduct depends on

WHAT'S NEW! CARES Act QIP correction increases deductions — retroactively

Prior to the TCJA, qualified retail improvement property, restaurant property and leasehold improvement property were depreciated over 15 years under the modified accelerated cost recovery system (MACRS). The TCJA classifies all of these property types as qualified improvement property (QIP).

Congress intended QIP placed in service after 2017 to have a 15-year MACRS recovery period and, in turn, qualify for 100% bonus depreciation. Bonus depreciation is additional first-year depreciation of 100% for qualified property placed in service through Dec. 31, 2022. For 2023 through 2026, bonus depreciation is scheduled to be gradually reduced.

But the statutory language didn't define QIP as 15-year property. So QIP defaulted to a 39-year recovery period, making it ineligible for bonus depreciation.

The CARES Act corrected this drafting error. Taxpayers that have made qualified improvements during the past two years can claim an immediate tax refund for the bonus depreciation they missed. Taxpayers investing in QIP in 2020 and beyond also can claim bonus depreciation going forward, according to the phaseout schedule. In some cases, however, it might be more beneficial to claim depreciation over 15 years.

Warning: Under the TCJA, real estate businesses that elect to deduct 100% of their business interest are ineligible for bonus depreciation.

whether the home is classified as a rental property for tax purposes (based on the amount of personal vs. rental use):

Rental property. You can deduct rental expenses, including losses, subject to the real estate activity rules discussed at right. Property tax attributable to the rental use of the home isn't subject to the SALT limit. You can't deduct any interest that's attributable to your personal use of the home. However, you can take the personal portion of property tax as an itemized deduction (subject to the SALT limit).

Nonrental property. You can deduct rental expenses only to the extent of your rental or other passive income. Any excess can be carried forward to offset rental income in future years. You also can take an itemized deduction for the personal portion of both mortgage interest and property taxes, subject to the applicable limits. In some instances, it may be beneficial to reduce personal use of a residence so it will be classified as a rental property.

Home sales

When you sell your principal residence, you can exclude up to \$250,000 of gain (\$500,000 for married couples filing jointly) if you meet certain tests. Gain that qualifies for exclusion will also be excluded from the 3.8% NIIT. (See page 11.) To support an accurate tax basis, maintain thorough records, including information on your original cost and subsequent improvements, reduced by any casualty losses and depreciation claimed based on business use. **Warning:** Gain that's allocable to a period of "non-qualified" use generally isn't excludable.

Losses on the sale of any personal residence aren't deductible. But if part of your home is rented out or used exclusively for your business, the loss attributable to that portion may be deductible.

Because a second home is ineligible for the gain exclusion, consider converting it to rental use before selling. It can be considered a business asset, and you may be able to defer tax on any gains through an installment sale or a Section 1031 exchange. Or you may be able to deduct a loss, but only to the extent attributable to a decline in value *after* the conversion.

WHAT'S NEW! CARES Act temporarily eases TCJA interest deduction rules

Generally, under the TCJA, interest paid or accrued by a business is deductible only up to 30% of adjusted taxable income (ATI). Taxpayers with average annual gross receipts of \$25 million or less for the three previous tax years generally are exempt from the limitation. Larger real property businesses can *elect* to continue to fully deduct their interest, but then they're required to use the alternative depreciation system for real property used in the business.

The CARES Act increases the interest expense deduction limit to 50% of ATI for the 2019 and 2020 tax years. (Special partnership rules apply for 2019.) It also permits businesses to elect to use 2019 ATI, rather than 2020 ATI, for the 2020 calculation, which may increase the amount of the deduction.

If these changes reduce your tax liability for 2019, you may be able to file an amended return to receive a refund now.

Real estate activity rules

Income and losses from investment real estate or rental property are passive by definition — unless you're a real estate professional. Why is this important? Passive activity income and losses have some negative tax consequences. (See "Passive activities" on page 10.)

To qualify as a real estate professional, you must annually perform:

- ▲ More than 50% of your personal services in real property trades or businesses in which you materially participate, and
- ▲ More than 750 hours of service in these businesses during the year.

Keep in mind that special rules for spouses may help you meet the material participation test. **Warning:** To help withstand IRS scrutiny, be sure to keep adequate records of time spent.

Depreciation-related breaks

Valuable depreciation-related breaks may be available to real estate investors. One such break is the Sec. 179 expensing election. It allows you to deduct (rather than depreciate over a number of years) qualified improvement property — a definition expanded by the TCJA from leasehold-improvement, restaurant and retail-improvement property.

The TCJA also allows Sec. 179 expensing for certain depreciable tangible personal property used predominantly to furnish lodging and

for the following improvements to nonresidential real property: roofs, HVAC equipment, fire protection and alarm systems, and security systems.

For qualifying property placed in service in 2020, the expensing limit is \$1.04 million. The break begins to phase out dollar-for-dollar when asset acquisitions for the year exceed \$2.59 million. (These amounts are adjusted annually for inflation.)

Other valuable breaks include bonus depreciation and accelerated depreciation. (See "What's new!" at left.)

Tax-deferral strategies

It's possible to divest yourself of appreciated investment real estate but defer the tax liability. Such strategies may even help you keep your income low enough to avoid triggering the 3.8% NIIT and the 20% long-term capital gains rate. Consider these deferral strategies:

Installment sale. An installment sale allows you to defer gains by spreading them over several years as you receive the proceeds. **Warning:** Ordinary gain from certain depreciation recapture is recognized in the year of sale, even if no cash is received.

Sec. 1031 exchange. Also known as a "like-kind" exchange, this technique allows you to exchange one real estate investment property for another and defer paying tax on any gain until you sell the replacement property. Discuss the limits and risks with your tax advisor. ■

Don't forget about tomorrow while addressing today's challenges



This has been a challenging year for business owners. Many have had to focus on doing everything they can just to keep their business afloat, while others have had to respond to increased demand for their products or services coupled with supply chain disruptions and staffing issues. At the same time, owners must keep their eye on available tax breaks and their own financial future, which requires keeping a long-term outlook as well.

Business structure

Income taxation and owner liability are the main factors that differentiate one business structure from another. Many business owners choose entities that combine pass-through taxation with limited liability, namely limited liability companies (LLCs) and S corporations. The TCJA significantly changed the tax consequences of business structure.

The now-flat corporate rate (21%) is significantly lower than the top individual rate (37%), providing significant tax benefits to C corporations and helping to mitigate the impact of double taxation for their owners. But, the TCJA also introduced a powerful deduction for owners of pass-through entities. (See below.)

For tax or other reasons, a structure change may be beneficial in certain situations. But there also may be unwelcome tax consequences that effectively prevent such a change.

Sec. 199A deduction for pass-through businesses

Through 2025, the TCJA provides the Sec. 199A deduction for sole proprietors and owners of pass-through business entities, such as partnerships, S corporations and LLCs that are

treated as sole proprietorships or as partnerships for tax purposes. The deduction generally equals 20% of qualified business income (QBI), subject to limitations that can begin to apply if taxable income exceeds the applicable threshold — \$163,300 or, if married filing jointly, \$326,600. The limits fully apply when taxable income exceeds \$213,300 and \$426,600, respectively.

QBI is generally defined as the net amount of qualified items of income, gain, deduction and loss that are effectively connected with the conduct of a U.S. business.

When the income-based limit applies to owners of pass-through entities, the 199A deduction generally can't exceed the greater of the owner's share of:

- ▲ 50% of the amount of W-2 wages paid to employees by the qualified business during the tax year, or
- ▲ The sum of 25% of W-2 wages plus 2.5% of the cost of qualified property.

Another limitation for taxpayers subject to the income-based limit is that the 199A deduction generally isn't available for income from "specified service businesses." Examples include businesses

WHAT'S NEW! CARES Act helps struggling business owners by enhancing tax breaks for losses

To provide COVID-19 relief, the CARES Act has made some temporary changes to tax breaks related to business losses. A loss occurs when a business's expenses and other deductions for the year exceed its revenues:

1. **Net operating losses (NOLs).** For NOLs that arise in 2018 and later tax years, the TCJA generally reduces the maximum amount of taxable income that can be offset with NOL deductions from 100% to 80%. In addition, the TCJA generally prohibits NOLs incurred in 2018 and later tax years from being carried back to an earlier tax year — but it allows them to be carried forward indefinitely (as opposed to the 20-year limit under pre-TCJA law).

Under the CARES Act, taxpayers are now eligible to carry back NOLs arising in 2018 through 2020 tax years to the previous five tax years. The CARES Act also allows taxpayers to potentially claim an NOL deduction equal to 100% of taxable income for prior-year NOLs carried forward into tax years beginning before 2021.

2. **Pass-through entity "excess" business losses.** Through 2025, the TCJA applies a limit to deductions for current-year business losses incurred by non-corporate taxpayers: Such losses generally can't offset more than \$250,000 (\$500,000 for married couples filing jointly) of income from other sources, such as salary, self-employment income, interest, dividends and capital gains. (The limit is annually adjusted for inflation.) "Excess" losses are carried forward to later tax years and can then be deducted under the NOL rules.

The CARES Act temporarily eliminates the limitation. These taxpayers can now deduct 100% of business losses arising in 2018, 2019 and 2020.

If any of these changes reduce your tax liability for 2018 or 2019, you may be able to file amended returns to receive a refund now.

that provide investment-type services and most professional practices (other than engineering and architecture).

The W-2 wage and property limitations and the service business limitation don't apply if your taxable income is under the applicable threshold. In that case, you should qualify for the full 20% deduction.

Retirement saving

If most of your money is tied up in your business, retirement can be a challenge. So if you haven't already set up a tax-advantaged retirement plan, consider doing so this year. If you might be subject to the 3.8% NIIT (see page 11), this may be particularly beneficial because retirement plan contributions can reduce your modified adjusted gross income (MAGI) and thus help you reduce or avoid the NIIT. Keep in mind that, if you have employees, they generally must be allowed to participate in the plan, provided they work enough hours and meet other qualification requirements. Here are a few options:

Profit-sharing plan. This is a defined contribution plan that allows discretionary employer contributions and flexibility in plan design. You can make deductible 2020 contributions (see Chart 4 for limits) as late as the due date of your 2020 income tax return, including extensions — provided your plan exists on Dec. 31, 2020.

SEP. A Simplified Employee Pension is a defined contribution plan that provides benefits similar to those of a profit-sharing plan. But you can establish a SEP in 2021 and still make deductible 2020 contributions as late as the due date of your 2020 income tax return, including extensions. (See Chart 4 for contribution limits.)

Defined benefit plan. This plan sets a future pension benefit and then actuarially calculates the contributions needed to attain that benefit. The maximum compensation for benefit purposes for 2020 is generally \$230,000 or 100% of average earned income for the highest three consecutive years, if less. Because it's actuarially driven, the 2020 contribution needed to attain the future benefit may exceed the maximum contributions allowed by other plans, depending on your age and the desired benefit.

CHART 4 Profit-sharing plan vs. SEP: How much can you contribute?

| Profit-sharing plan | SEP |
|---|---|
| 2020 maximum contribution: \$57,000 or \$63,500 | 2020 maximum contribution: \$57,000 |
| Additional limits: You can't contribute more than 25% of your compensation generally. But you can contribute 100% up to the 401(k) limits if the plan includes a 401(k) arrangement. To qualify for the \$63,500 limit, your plan must include a 401(k) arrangement. And you must be eligible to make catch-up contributions (that is, be age 50 or older). | Additional limits: You can't contribute more than 25% of your eligible compensation. (Special rules apply if you're self-employed.) To make the maximum contribution, your eligible compensation must be at least \$228,000 (\$285,000 before the deduction if you're self-employed). |
| Note: Other factors may further limit your maximum contribution. | |

You can make deductible 2020 contributions until the due date of your 2020 income tax return, including extensions — provided your plan exists on Dec. 31, 2020. **Warning:** Employer contributions generally are required.

Exit planning

An exit strategy is a plan for passing on responsibility for running the company, transferring ownership and extracting your money from the business. This requires planning well in advance of the transition. Here are the most common exit options:

Buy-sell agreement. When a business has more than one owner, a buy-sell agreement can control what happens to the business when a specified event occurs, such as an owner's retirement, disability or death. It's critical to factor in tax and funding issues when drafting a buy-sell agreement.

Succession within the family. You can pass your business on to family members by giving them interests, selling them interests or doing some of each. Now may be a particularly good time to transfer ownership interests in your business. (See page 22 to learn why.)

ESOP. An employee stock ownership plan is a qualified retirement plan created primarily to purchase your company's stock. It can provide liquidity and various tax benefits.

Sale to an outsider. If you can find the right buyer, you may be able to sell the business at a premium.

Sale or acquisition

Whether you're selling your business as part of an exit strategy or acquiring another company to help grow your business, the tax consequences can have a major impact on the transaction's success or failure. Consider installment sales, for example. A taxable sale might be structured as an installment sale if the buyer lacks sufficient cash or pays a contingent amount based on the business's performance.

An installment sale also may make sense if the seller wishes to spread the gain over a number of years. This could be especially beneficial if it would allow the seller to stay under the thresholds for triggering the 3.8% NIIT or the 20% long-term capital gains rate. But an installment sale can backfire on the seller. For example:

- ▲ Depreciation recapture must be reported as gain in the year of sale, no matter how much cash the seller receives.
- ▲ If tax rates increase, the overall tax could wind up being more.

With a corporation, a key consideration is whether the deal should be structured as an asset sale or a stock sale. If a stock sale is chosen, another important question is whether it should be a tax-deferred transfer or a taxable sale.

Of course, tax consequences are only one of many important considerations when planning a sale or acquisition. ■

Donations may be more impactful this year — to you and the recipients



The events of 2020 have caused many charities to need support more than ever. In addition, the CARES Act includes some tax incentives for donating this year. If you can still afford to give and you keep in mind the various rules and limits, such as that you generally must itemize tax deductions to benefit, charitable giving can play a key role in your tax planning while you support organizations whose missions are important to you.

Cash donations

Outright gifts of cash (which include donations made via check, credit card and payroll deduction) are the easiest to make. The substantiation requirements depend on the gift's value:

- ▲ Gifts under \$250 can be supported by a canceled check, credit card receipt or written communication from the charity.
- ▲ Gifts of \$250 or more must be substantiated by the charity.

Deductions for cash gifts to public charities normally can't exceed 60% of your adjusted gross income (AGI), but this limit has been substantially increased for 2020. (See "What's new!" on page 17.) The AGI limit remains at 30% for cash donations to nonoperating private foundations. Contributions exceeding the applicable AGI limit can be carried forward for up to five years.

Warning: Charitable contribution deductions are allowed for alternative minimum tax (AMT) purposes, but your tax savings may be less if you're subject to the AMT. For example, if you're in the 37% tax bracket for regular income tax purposes, but the 28% tax bracket for AMT purposes, your deduction may be worth only 28% instead of 37%.

Stock donations

Appreciated publicly traded securities you've held more than one year are long-term capital gains property, which often makes one of the best charitable gifts. Why? You can deduct the current fair market value and avoid the capital gains tax you'd pay if you sold the property. This will be especially beneficial to taxpayers facing the 3.8% NIIT (see page 11) or the top 20% long-term capital gains rate this year.

Donations of long-term capital gains property are subject to tighter deduction limits, however — 30% of AGI for gifts to public charities, 20% for gifts to nonoperating private foundations. In some situations, the

increased AGI limit for cash gifts to public charities might mean that cash gifts will make more sense in 2020. (See "What's new! at right.)

Don't donate stock that's worth less than your basis. Instead, sell the stock so you can deduct the loss and then donate the cash proceeds to charity.

IRA donations

Taxpayers age 70½ or older are allowed to make direct contributions from their IRA to qualified charitable organizations, up to \$100,000 per tax year. Note that the age for these qualified charitable distributions (QCDs) hasn't changed even though the SECURE Act increased the age after which

CHART 5 How much can you deduct for your donation?

Cash. This includes not just actual cash but gifts made by check, credit card or payroll deduction. You may deduct 100%.

Ordinary-income property. Examples include stocks and bonds held one year or less, inventory, and property subject to depreciation recapture. You generally may deduct only the lesser of fair market value or your tax basis.

Long-term capital gains property. You may deduct the current fair market value of appreciated stocks, bonds and other securities and real estate held more than one year.

Tangible personal property. Your deduction depends on the situation:

- If the property *isn't* related to the charity's tax-exempt function (such as an antique donated for a charity auction), your deduction is limited to your basis.
- If the property *is* related to the charity's tax-exempt function (such as an antique donated to a museum for its collection), you can deduct the fair market value.

Vehicle. Unless it's being used by the charity, you generally may deduct only the amount the charity receives when it sells the vehicle.

Use of property. Examples include use of a vacation home and a loan of artwork. Generally, you receive no deduction because it isn't considered a completed gift. There may, however, be ways to structure the gift to enable you to get a deduction.

Services. You may deduct only your out-of-pocket expenses, not the fair market value of your services. You can deduct 14 cents per charitable mile driven.

Payments made in exchange for college athletic event seating rights. Under the TCJA, these are no longer deductible.

Note: Nonitemizers are limited to deducting \$300 of cash donations for 2020. If you itemize, your annual charitable deductions may be reduced if they exceed certain limits based on your AGI, the type of donation and the type of charity receiving the donation. If you receive some benefit from the charity relating to your donation, such as services or products, your deduction must be reduced by the value of the benefit you receive. Various substantiation requirements also apply. Consult your tax advisor for additional details.

required minimum distributions (RMDs) generally must begin from 70½ to 72. (See page 21.)

A charitable deduction can't be claimed for QCDs. But QCDs aren't included in taxable income and can be used to satisfy an IRA owner's RMD — though RMDs have been waived for 2020. (See page 21.)

A QCD might be tax-smart if you won't benefit from the charitable deduction. To be a QCD, the transfer must be made by the IRA trustee directly to an eligible charity.

Making gifts over time

If you don't know which charities you want to benefit but you'd like to start making large contributions now, consider a private foundation. It offers you significant control over how your donations ultimately will be used. You must comply with complex rules, however, which can make foundations expensive to run. Also, the AGI limits for deductibility of contributions to nonoperating foundations are lower. (See "Cash donations" and "Stock donations.")

If you'd like to influence how your donations are spent but avoid a foundation's downsides, consider a donor-advised fund (DAF). Many larger public charities and investment firms offer them. **Warning:** To deduct your DAF contribution, obtain a written acknowledgment from the sponsoring organization that it has exclusive legal control over the assets contributed.

Charitable remainder trusts

To benefit a charity while helping ensure your own financial future, consider a CRT. Here's how it works:

- ▲ For a given term, the CRT pays an amount to you annually (some of which generally is taxable).
- ▲ At the term's end, the CRT's remaining assets pass to one or more charities.
- ▲ When you fund the CRT, you receive an income tax deduction for the present value of the amount that will go to charity.
- ▲ The property is removed from your taxable estate.

WHAT'S NEW! CARES Act boosts tax benefits of charitable giving this year

Making large *cash* donations to public charities this year might be beneficial because the CARES Act increased the 2020 deduction limit for such gifts from 60% of adjusted gross income (AGI) to 100% of AGI. Normally donations of appreciated stock provide the biggest tax-saving opportunities, but this year cash donations might prove more beneficial because of the 100% of AGI deduction limit.

If you *don't* itemize deductions, normally you can't deduct charitable donations. But, the CARES Act allows taxpayers who claim the standard deduction to deduct up to \$300 of cash donations to qualified charities in 2020.

Also keep in mind that, if itemizing no longer will save you tax because of the increased standard deduction, you might benefit from "bunching" donations into alternating years so that your total itemized deductions in those years would then surpass your standard deduction. You can then itemize just in those years.

You may owe capital gains tax when you receive the payments. However, because the payments are spread over time, much of the liability will be deferred. Plus, a portion of each payment might be considered tax-free return of principal. This may help you reduce or avoid exposure to the 3.8% NIIT and the 20% top long-term capital gains rate.

You can name someone other than yourself as income beneficiary or fund the CRT at your death, but the tax consequences will be different.

Charitable lead trusts

To benefit charity while transferring assets to loved ones at a reduced tax cost, consider a CLT. It works as follows:

- ▲ For a given term, the CLT pays an amount to one or more charities.
- ▲ At the term's end, the CLT's remaining assets pass to one or more loved ones you name as remainder beneficiaries.
- ▲ When you fund the CLT, you make a taxable gift equal to the present value of the amount that will go to the remainder beneficiaries.
- ▲ The property is removed from your taxable estate.

For gift tax purposes, the amount of the remainder interest is determined using the assumption that the trust assets will grow at the Section 7520 rate. The lower the Sec. 7520 rate, the smaller the remainder interest and the lower the possible gift tax — or the less of

your lifetime gift tax exemption you'll have to use up. If the trust's earnings outperform the Sec. 7520 rate, the excess earnings will be transferred to the remainder beneficiaries gift- and estate-tax-free.

Because the Sec. 7520 rate is currently very low, now may be a good time to lock in a low rate while still available and take the chance that your actual return will outperform it. Keep in mind, however, that the increased gift and estate tax exemption may reduce the tax benefits of a CLT, depending on your specific situation. (For more on estate and gift taxes, see page 22.)

You can name yourself as the remainder beneficiary or fund the CLT at your death, but the tax consequences will be different.

Qualified charities

Before you donate, it's critical to make sure the charity you're considering is indeed a qualified charity — that it's eligible to receive tax-deductible contributions.

The IRS's online search tool, Tax Exempt Organization Search, can help you more easily find out whether an organization is eligible to receive tax-deductible charitable contributions. You can access the tool at [IRS.gov](https://www.irs.gov). According to the IRS, you may rely on this list in determining deductibility of your contributions.

Also, don't forget that political donations aren't deductible. ■

Focusing in on children's financial future



When it comes to family and education, much of the focus in 2020 has been on the impact of the COVID-19 crisis, such as managing remote learning and finding creative ways for grandparents and grandchildren to safely connect. But whether you're a parent or a grandparent, it's still important to also do what you can to start the children in your life off on the right financial track. This includes showing them the value of saving and providing them with the best education possible. By taking advantage of tax breaks, your family can do both.

Child credit

Some higher-income taxpayers who couldn't benefit from the child credit before the TCJA went into effect are now finding that they do. The TCJA has significantly raised the modified adjusted gross income (MAGI) phase-out ranges for the credit. Through 2025, the total credit amount a taxpayer is allowed to claim is reduced by \$50 for every \$1,000 (or part of a \$1,000) by which MAGI exceeds \$200,000, or \$400,000 for married couples filing jointly. The thresholds used to be only \$75,000 and \$110,000, respectively.

Tax credits reduce your tax bill dollar for dollar (unlike deductions, which just reduce the amount of income subject to tax), so they're particularly valuable. Under the TCJA:

- ▲ For each child under age 17 at the end of 2020, you may be able to claim a \$2,000 credit.
- ▲ For each qualifying dependent other than a qualifying child (such as a dependent child age 17 or older or a dependent elderly parent), a \$500 family credit may be available.

If you adopt, you might be eligible for the adoption credit. It's \$14,300 for 2020, but it's subject to a MAGI-based phaseout that's lower than for the child credit (\$214,520–\$254,520 for both heads of households and joint filers).

"Kiddie tax"

The "kiddie tax" generally applies to unearned income beyond \$2,200 (for 2020) of children under age 19 and of full-time students under age 24 (unless the students provide more

than half of their own support from earned income). The TCJA had made the kiddie tax harsher, taxing income subject to the tax according to the tax brackets used for trusts and estates.

Before 2018, such income was generally taxed at the parents' tax rate. In many cases, the TCJA would have caused children's unearned income to be taxed at higher rates than their parents' income, because higher rates kick in at much lower income levels for trusts and estates.

CASE STUDY 6

Why Roth IRAs are tax-smart for teens

Madison, 16, is starting her first part-time job this year. Madison's parents would like to get her in the habit of saving for the future, and they ask their tax advisor for the most tax-advantaged option. He suggests a Roth IRA, which can be perfect for teenagers because they likely have many decades to let their accounts grow tax-free.

Roth IRA contributions aren't deductible, but if Madison earns no more than the standard deduction for singles (\$12,400 for 2020) and has no unearned income, she'll pay zero federal income tax anyway. So the tax-free treatment of future qualified distributions will be well worth the loss of any current deduction. Even if Madison's earned income exceeds the standard deduction, she'll probably be taxed at a very low rate. So the long-term tax benefits of a Roth IRA will typically

still outweigh the benefit of a current deduction with a traditional IRA.

If Madison doesn't want to invest too much of her hard-earned money, her parents could give her some of the amount she's eligible to contribute. For example, if Madison earns \$6,000 for the year but only wants to contribute \$1,000 of it to the Roth IRA, her parents could give her \$5,000 so she could contribute the full \$6,000 she's eligible to contribute but still have \$5,000 to spend as she wishes (or save for a shorter-term goal). But Madison's parents should first consider any potential gift tax or college financial aid consequences.



Fortunately, tax legislation signed into law at the end of 2019 returned the kiddie tax to pre-TCJA law, retroactive to 2018. If your family paid the kiddie tax for 2018 under the TCJA rules, you might be eligible for a refund for a portion of that tax.

529 plans

Section 529 plans provide another tax-advantaged savings opportunity. You can choose a prepaid tuition plan to secure current tuition rates or a tax-advantaged savings plan to fund education expenses. Here are some of the possible benefits of such plans:

- ▲ Although contributions aren't deductible for federal purposes, any growth is tax-deferred. (Some states do offer tax breaks for contributing.)
- ▲ The plans usually offer high contribution limits, and there are no income limits for contributing.
- ▲ There's generally no beneficiary age limit for contributions or distributions.
- ▲ You can control the account, even after the child is of legal age.
- ▲ You can make tax-free rollovers to another qualifying family member.
- ▲ A special break for 529 plans allows you to front-load five years' worth of annual gift tax exclusions and make up to a \$75,000 contribution (or \$150,000 if you split the gift with your spouse) per beneficiary in 2020.

Prepaid tuition vs. savings plan

With a 529 *prepaid tuition plan*, if your contract is for four years of tuition, tuition is guaranteed regardless of its cost at the time the beneficiary actually attends the school. One downside is that there's uncertainty in how benefits will be applied if the beneficiary attends a different school. Another negative is that the plan doesn't cover costs other than tuition, such as room and board.

A 529 *college savings plan*, on the other hand, can be used to pay a student's expenses at most postsecondary educational institutions. Distributions used to pay qualified postsecondary school expenses (such as tuition,

mandatory fees, books, supplies, computer equipment, software, Internet service and, generally, room and board) are income-tax-free for federal purposes and typically for state purposes as well, making the tax deferral a permanent savings.

The TCJA permanently allows tax-free distributions for elementary and secondary school tuition up to \$10,000 per year per student. The SECURE Act further expands 529 plans by allowing them to be used to pay up to \$10,000 of student loans per beneficiary.

The biggest downside may be that you don't have direct control over investment decisions; you're limited to the options the plan offers. Additionally, for funds already in the plan, you can make changes to your investment options only twice during the year or when you change beneficiaries. For these reasons, some taxpayers prefer Coverdell ESAs.

But each time you make a new contribution to a 529 savings plan, you can select a different option for that contribution, regardless of how many times you contribute throughout the year. And every 12 months you can make a tax-free rollover to a different 529 plan for the same child.

ESAs

Coverdell Education Savings Accounts are like 529 savings plans in that contributions aren't deductible for federal purposes, but plan assets can grow tax-deferred and distributions used to pay qualified education expenses are income-tax-free.

One of the biggest ESA advantages used to be that they allowed tax-free distributions for elementary and secondary school costs and 529 plans didn't. With the TCJA enhancements to 529 plans, this is less of an advantage. But ESAs still have a leg up because they can be used for elementary and secondary school expenses other than just tuition — and there's no dollar limit on these annual distributions. Another advantage is that you have more investment options.

ESAs are worth considering if you'd like to have direct control over how your contributions are invested or if you want to fund elementary or secondary education expenses in excess of \$10,000 per year or that aren't tuition.

But the \$2,000 contribution limit is low, and it begins to phase out at a MAGI of \$190,000 for married couples filing jointly and \$95,000 for other filers. No contribution can be made when MAGI hits \$220,000 and \$110,000, respectively.

Also, contributions can generally be made only for beneficiaries under age 18. When the beneficiary turns age 30, the ESA generally must be distributed within 30 days, and any earnings may be subject to tax and a 10% penalty.

ABLE accounts

Achieving a Better Life Experience accounts offer a tax-advantaged way to fund qualified disability expenses for a beneficiary who became blind or disabled before age 26. For federal purposes, tax treatment is similar to that of Sec. 529 college savings plans.

Under the TCJA, through 2025, 529 plan funds can be rolled over to an ABLE account without penalty if the ABLE account is owned by the beneficiary of the 529 plan or a member of the beneficiary's family. Such rolled-over amounts count toward the ABLE account annual rollover and contribution limit (\$15,000 for 2020).

American Opportunity credit

When your child enters college, you may not qualify for the American Opportunity credit because your income is too high (phaseout range of \$80,000–\$90,000; \$160,000–\$180,000 for joint filers), but your child might. The maximum credit, *per student*, is \$2,500 per year for the first four years of postsecondary education. And both the credit and a tax-free 529 plan or ESA distribution can be taken as long as expenses paid with the distribution aren't used to claim the credit. ■

Leverage the might of tax-advantaged retirement plans — and avoid tax traps



Although you're allowed to contribute only a limited amount to tax-advantaged retirement plans, those tax advantages make the plans especially powerful for taxpayers in the top income tax brackets. But it's also important to revisit your retirement plans this year in light of new tax law changes plus the impact of the COVID-19 crisis. Only then can you minimize taxes and maximize returns.

Retirement plan contributions

Contributing the maximum you're allowed (see Chart 6) to an employer-sponsored defined contribution plan, such as a 401(k), is likely a smart move:

- ▲ Contributions are typically pretax, reducing your modified adjusted gross income (MAGI). This in turn can help you reduce or avoid exposure to the 3.8% NIIT. (See page 11.)
- ▲ Plan assets can grow tax-deferred — meaning you pay no income tax until you take distributions.
- ▲ Your employer may match some or all of your contributions.

If you participate in a 401(k), 403(b) or 457 plan, it may allow you to designate some or all of your contributions as Roth contributions. While Roth contributions don't reduce your current MAGI, qualified distributions will be tax-free. Roth contributions may be especially beneficial for higher-income earners, who are ineligible to contribute to a Roth IRA.

Roth IRA conversions

If you have a traditional IRA, a partial or full conversion to a Roth IRA can allow you to turn tax-deferred future growth into tax-free growth. It also can provide estate planning advantages. Unlike other retirement plans, Roth IRAs don't require you to take distributions during your lifetime, so you can let the entire balance grow tax-free for the benefit of your heirs.

But the converted amount is taxable in the year of the conversion. With tax rates particularly low now under the TCJA (and perhaps a better chance that your rate at retirement will be higher), it may be a good time for a Roth conversion. Your tax advisor can run the numbers and help you decide if a conversion is right for you this year.

If you *don't* have a traditional IRA, consider a “back door” Roth IRA: You set up a traditional account and make a nondeductible contribution to it. You then wait until the transaction clears and convert the traditional account to a Roth account. The only tax due will be on any growth in the account between the time you made the contribution and the date of conversion.

Early withdrawals

With a few exceptions (see “What's new!” above right for a 2020 exception), retirement plan distributions before age 59½ are subject to a 10% penalty on top of any income tax that ordinarily would be due on a withdrawal. This means that, if you're in the top tax bracket of 37%, you can lose almost half of your withdrawal to taxes and penalties — and perhaps more than half if you're also subject to state income taxes and/or penalties. Additionally, you'll lose the potential tax-deferred future growth on the withdrawn amount.

If you have a Roth account, you can withdraw up to your contribution amount without incurring taxes or penalties. But you'll be losing the potential tax-free growth on the withdrawn amount.

So if you're in need of cash, consider tapping your taxable investment accounts rather than dipping into your retirement plan. (See page 8 for information on the tax treatment of investments.)

Leaving a job

When you change jobs or retire, avoid taking a lump-sum distribution from your employer's retirement plan because it generally will be taxable — and potentially subject to the 10% early-withdrawal penalty. These options help avoid current income tax and penalties:

CHART 6 Retirement plan contribution limits for 2020

| | Regular contribution | Catch-up contribution ¹ |
|---|----------------------|------------------------------------|
| Traditional and Roth IRAs | \$ 6,000 | \$ 1,000 |
| 401(k)s, 403(b)s, 457s and SARSEPs ² | \$ 19,500 | \$ 6,500 |
| SIMPLEs | \$ 13,500 | \$ 3,000 |

¹ For taxpayers age 50 or older by the end of the tax year.

² Includes Roth versions where applicable.

Note: Other factors may further limit your maximum contribution. If you're a business owner or self-employed, you may be able to set up a plan that allows you to make much larger contributions. (See Chart 4 on page 15.)

Staying put. You may be allowed to leave your money in your old plan. But if you'll be participating in a new employer's plan or you already have an IRA, keeping track of multiple plans can make managing your retirement assets more difficult.

A rollover to your new employer's plan. If you're changing jobs and this will leave you with only one retirement plan to keep track of, it may be a good solution. But evaluate how well the new plan's investment options meet your needs.

A rollover to an IRA. If you participate in a new employer's plan, this will require keeping track of two plans. But it may be the best alternative because IRAs offer nearly unlimited investment choices.

If you choose a rollover, request a *direct* rollover from your old plan to your new plan or IRA. If the funds are sent to you by check, you'll need to make an *indirect* rollover within 60 days to avoid tax and potential penalties.

Warning: If you don't do a direct rollover, the check you receive from your old plan may be net of 20% federal income tax withholding. Your subsequent indirect rollover must be of the gross amount (making up for the withheld amount with other funds) or you'll be subject to income tax — and potentially the 10% penalty — on the difference.

WHAT'S NEW!

CARES Act provides retirement plan relief

In response to the COVID-19 crisis, the CARES Act provides some temporary relief to retirement plan owners:

1. **Owners who need funds from their accounts to help them financially survive the crisis.** The act waives the 10% early withdrawal penalty — along with providing additional tax advantages that taxpayers age 59½ and older can also benefit from — on COVID-19-related distributions up to \$100,000. These generally are 2020 withdrawals made by someone who has been (or whose family has been) infected with COVID-19 or who has been economically harmed by the virus.

Distributions may be recontributed to the retirement plan over the three-year period starting the day after the withdrawal. If distributions *aren't* recontributed, income tax payments can be spread out over three years. Many additional rules apply, so contact your tax advisor for details.

2. **Owners who *don't* need funds from their accounts this year.** The act waives retirement plan required minimum distributions for 2020. This potentially allows taxpayers to avoid having to sell plan investments during a down market, giving time to recover lost value and providing continued tax deferral.

RMDs

Historically, after a taxpayer has reached age 70½, he or she has had to begin to take annual required minimum distributions from his or her IRAs (except Roth IRAs) and, generally, from any defined contribution plans. However, the age has increased — see “What's new!” below. In addition, the RMD rule has been waived for 2020 — see “What's new!” above.

When RMD rules apply, if you don't comply, you can owe a penalty equal to 50% of the amount you should have withdrawn but didn't. You can avoid the RMD rule for a non-IRA Roth plan by rolling the funds into a Roth IRA.

Waiting as long as possible to take distributions generally is advantageous because of tax-deferred compounding. But a distribution (or larger distribution) in a year your tax rate is lower than usual may save tax.

Be sure, however, to consider the lost future tax-deferred growth and, if applicable, whether the distribution could: 1) cause Social Security payments to become taxable, 2) increase income-based Medicare premiums and prescription drug charges, or 3) affect other tax breaks with income-based limits.

Warning: While retirement plan distributions aren't subject to the additional 0.9% Medicare tax (see page 4) or 3.8% NIIT, they are included in your MAGI. That means they could trigger or increase the NIIT, because the thresholds for that tax are based on MAGI.

If you've inherited a retirement plan, consult your tax advisor about the distribution rules that apply to you. ■

WHAT'S NEW!

Could you be affected by SECURE Act changes?

The Setting Every Community Up for Retirement Enhancement (SECURE) Act, signed into law in late 2019, makes a variety of tax law changes related to retirement plans. Here are some key changes that could affect you:

- Allows penalty-free IRA withdrawals of up to \$5,000 for the birth or adoption of a child,
- Repeals the maximum age of 70½ for making traditional IRA contributions,
- Increases the age for beginning required minimum distributions (RMDs) from age 70½ to age 72, for taxpayers who didn't turn age 70½ before Jan. 1, 2020 (that is, were born *after* June 30, 1949), and
- Reduces the time period for taking IRA distributions to 10 years for beneficiaries — other than surviving spouses and certain others — inheriting IRAs after Dec. 31, 2019.

The SECURE Act also includes many provisions intended to make employer-sponsored retirement plans more readily available. Contact your tax advisor or employee benefits advisor for more details.



Taking the right steps now can save taxes later



Estate planning is about much more than reducing taxes; it's about ensuring your loved ones are provided for after you're gone and that your assets are passed on according to your wishes. And because the TCJA has put estate, gift and generation-skipping transfer (GST) tax exemptions at record-high levels, far fewer taxpayers are worrying about these taxes. But the high exemptions currently are available only through 2025. And it's possible the limits could be reduced sooner. So whether or not you'd be subject to estate taxes under the current exemptions, it's a good idea to consider whether there are steps you can take now to save taxes later.

Estate tax

While the TCJA keeps the estate tax rate at 40%, it has doubled the exemption base amount from \$5 million to \$10 million. The inflation-adjusted amount for 2020 is \$11.58 million. (See Chart 7.)

Without further legislation, the estate tax exemption will return to an inflation-adjusted \$5 million in 2026. So taxpayers with estates in the roughly \$6 million to \$11 million range (twice that for married couples), whose estates would escape estate taxes if they were to die while the doubled exemption is in effect, still need to keep potential post-2025 estate tax liability in mind in their estate planning. It's also possible the exemption could be reduced sooner than 2026.

Gift tax

The gift tax continues to follow the estate tax, so the gift tax exemption also has increased under the TCJA. (See

Chart 7.) Any gift tax exemption used during your lifetime reduces the estate tax exemption available at death. Using up some of your exemption during your lifetime can be tax-smart, especially if your estate exceeds roughly \$6 million (twice that if you're married). (See Case Study 7.)

You also can exclude certain gifts of up to \$15,000 per recipient in 2020 (\$30,000 per recipient if your spouse elects to split the gift with you or you're giving joint or community property) without depleting any of your gift and estate tax exemption.

Warning: Each year you need to use your annual exclusion by Dec. 31. The exclusion doesn't carry over from year to year. For example, if you don't make an annual exclusion gift to your granddaughter this year, you can't add \$15,000 to your 2021 exclusion to make a \$30,000 tax-free gift to her next year.

GST tax

The generation-skipping transfer (GST) tax generally applies to transfers (both during your lifetime and at death) made to people more than one generation below you, such as your grandchildren. This is in addition to any gift or estate tax due. The GST tax continues to follow the estate tax, so the GST tax exemption also has increased under the TCJA. (See Chart 7.)

The GST tax exemption can be a valuable tax-saving tool for taxpayers with large estates whose children also have — or may eventually have — large estates. With proper planning, they can use the exemption to make transfers to grandchildren and avoid any tax at their children's generation.

State taxes

Even before the TCJA, many states imposed estate tax at a lower threshold than the federal government did. Now the differences in some states are even more dramatic. To avoid unexpected tax liability or other unintended consequences, it's critical to consider state law. Consult a tax advisor familiar with the law of your particular state.

Exemption portability

If one spouse dies and part (or all) of his or her estate tax exemption is unused at his or her death, the estate can elect to permit the surviving spouse to use the deceased spouse's remaining estate tax exemption. This exemption "portability" provides flexibility at the time of the first spouse's death, but it has some limits. Portability is available only from the most recently deceased spouse, doesn't apply to the GST tax exemption and isn't recognized by many states.

CHART 7 2020 transfer tax exemptions and rates

| | Estate tax | Gift tax | GST tax |
|------------------|------------------------------|-----------------|-----------------|
| Exemption | \$11.58 million ¹ | \$11.58 million | \$11.58 million |
| Rate | 40% | 40% | 40% |

¹ Less any gift tax exemption already used during life.

And portability doesn't protect future growth on assets from estate tax like applying the exemption to a credit shelter (or bypass) trust does. Such a trust offers other benefits as well, such as creditor protection, remarriage protection, GST tax planning and possible state estate tax benefits.

So married couples should still consider these trusts — and consider transferring assets to each other to the extent necessary to fully fund them at the first death. Transfers to a spouse (during life or at death) aren't subject to gift or estate tax as long as he or she is a U.S. citizen.

Tax-smart giving

Giving away assets now will help reduce the size of your taxable estate. Here are some strategies for tax-smart giving:

Choose gifts wisely. Consider both estate and income tax consequences and the economic aspects of any gifts you'd like to make:

- ▲ To minimize *estate tax*, gift property with the greatest future appreciation potential.
- ▲ To minimize *your beneficiary's income tax*, gift property that hasn't appreciated significantly while you've owned it.
- ▲ To minimize *your own income tax*, don't gift property that's declined in value. Instead, consider selling the property so you can take the tax loss and then gifting the sale proceeds.

Plan gifts to grandchildren carefully.

Annual exclusion gifts are generally exempt from the GST tax, so they also help you preserve your GST tax exemption for other transfers. For gifts to a grandchild that don't qualify for the exclusion to be tax-free, you generally must apply both your GST tax exemption and your gift tax exemption.

Pay tuition and medical expenses.

You may pay these expenses without the payment being treated as a taxable gift to the student or patient, as long as the payment is made directly to the provider.

CASE STUDY 7

Taking advantage of valuation discounts



Celia had been planning to begin succession planning for her business in a few years. But with the events of 2020, she decided she should start planning sooner. So she made an appointment with her tax and estate planning advisors.

They recommended that she begin leveraging her gift tax exclusions and exemption by gifting ownership interests, which may be eligible for valuation

discounts. So, for example, if the combined discount is 25%, in 2020 she can gift an ownership interest equal to as much as \$20,000 tax-free because the discounted value doesn't exceed the \$15,000 annual exclusion.

If her business has declined in value because of 2020 events, a silver lining is that Celia may be able to transfer an even larger portion of her business tax-free.

But she doesn't want to transfer ownership interests to her children who aren't active in the business. Her advisors suggest that she can still potentially benefit from valuation discounts on transfers of other assets to them by setting up a family limited partnership. She can fund the FLP with public stock and real estate, and then gift limited partnership interests.

Celia's advisors warn her that the IRS may challenge valuation discounts; they recommend a professional, independent valuation. The IRS also scrutinizes FLPs, so she must be sure to properly set up and operate hers.

Make gifts to charity. Donations to qualified charities aren't subject to gift tax. They may also be eligible for an income tax deduction, but this deduction may benefit fewer taxpayers than in the past. (See page 16.)

Consider "taxable" gifts. Making some gifts beyond annual exclusion gifts and using some or all of your lifetime exemption can make sense if you have a large estate. These "taxable" gifts can protect transfers from gift and estate tax, even if the exemption drops in the future. They also remove the future appreciation from your estate.

You do, however, need to keep in mind your beneficiaries' income tax. Gifted assets don't receive the "step-up" in basis that bequeathed assets do. This means that, if beneficiaries sell assets gifted to them, their taxable capital gains will be determined based on *your* basis in the assets. So their capital gains tax could be higher than if they inherited the same assets.

Trusts

Trusts can provide a way to transfer assets and potentially enjoy some tax

savings while preserving some control over what happens to the transferred assets. For those with large estates, funding them now, while the gift tax exemption is high, may be particularly tax-smart. Here are some types of trusts to consider:

A qualified personal residence trust (QPRT). It allows you to give your home to your children today — removing it from your taxable estate at a reduced gift tax cost (provided you survive the trust's term) — while you retain the right to live in it for a certain period.

A grantor-retained annuity trust (GRAT). It works on the same principle as a QPRT, but allows you to transfer other assets; you receive payments back from the trust for a certain period.

A GST — or "dynasty" — trust. It can help you leverage both your gift and GST tax exemptions. And it can be an excellent way to potentially lock in the currently high exemptions while removing future appreciation from your estate. ■

CHART 8 2020 individual income tax rate schedules

| Regular tax brackets | | | | |
|----------------------|-------------------------|-------------------------|--|---------------------------|
| Tax rate | Single | Head of household | Married filing jointly or surviving spouse | Married filing separately |
| 10% | \$ 0 – \$ 9,875 | \$ 0 – \$ 14,100 | \$ 0 – \$ 19,750 | \$ 0 – \$ 9,875 |
| 12% | \$ 9,876 – \$ 40,125 | \$ 14,101 – \$ 53,700 | \$ 19,751 – \$ 80,250 | \$ 9,876 – \$ 40,125 |
| 22% | \$ 40,126 – \$ 85,525 | \$ 53,701 – \$ 85,500 | \$ 80,251 – \$ 171,050 | \$ 40,126 – \$ 85,525 |
| 24% | \$ 85,526 – \$ 163,300 | \$ 85,501 – \$ 163,300 | \$ 171,051 – \$ 326,600 | \$ 85,526 – \$ 163,300 |
| 32% | \$ 163,301 – \$ 207,350 | \$ 163,301 – \$ 207,350 | \$ 326,601 – \$ 414,700 | \$ 163,301 – \$ 207,350 |
| 35% | \$ 207,351 – \$ 518,400 | \$ 207,351 – \$ 518,400 | \$ 414,701 – \$ 622,050 | \$ 207,351 – \$ 311,025 |
| 37% | Over \$ 518,400 | Over \$ 518,400 | Over \$ 622,050 | Over \$ 311,025 |

| AMT brackets | | | | |
|--------------|-------------------|-------------------|--|---------------------------|
| Tax rate | Single | Head of household | Married filing jointly or surviving spouse | Married filing separately |
| 26% | \$ 0 – \$ 197,900 | \$ 0 – \$ 197,900 | \$ 0 – \$ 197,900 | \$ 0 – \$ 98,950 |
| 28% | Over \$ 197,900 | Over \$ 197,900 | Over \$ 197,900 | Over \$ 98,950 |

| AMT exemptions | | | | |
|-----------------------|-------------------------|-------------------------|--|---------------------------|
| | Single | Head of household | Married filing jointly or surviving spouse | Married filing separately |
| Amount | \$ 72,900 | \$ 72,900 | \$ 113,400 | \$ 56,700 |
| Phaseout ¹ | \$ 518,400 – \$ 810,000 | \$ 518,400 – \$ 810,000 | \$ 1,036,800 – \$ 1,490,400 | \$ 518,400 – \$ 745,200 |

¹ The AMT income ranges over which the exemption phases out and only a partial exemption is available. The exemption is completely phased out if AMT income exceeds the top of the applicable range.

Note: Consult your tax advisor for AMT rates and exemptions for children subject to the "kiddie tax."

CHART 9 2020 corporate income tax rates

| Tax rate | Type of corporation |
|----------|------------------------------|
| 21% | C corporation |
| 21% | Personal service corporation |

CHART 10 2020 estate and trust income tax rate schedule

| Tax rate | Tax brackets |
|----------|----------------------|
| 10% | \$ 0 – \$ 2,600 |
| 24% | \$ 2,601 – \$ 9,450 |
| 35% | \$ 9,451 – \$ 12,950 |
| 37% | Over \$ 12,950 |



This publication was developed by a third-party publisher and is distributed with the understanding that the publisher and distributor are not rendering legal, accounting or other professional advice or opinions on specific facts or matters and recommend you consult an attorney, accountant, tax professional, financial advisor or other appropriate industry professional. This publication reflects tax law as of Aug. 31, 2020. Some material may be affected by subsequent changes in the laws or in the interpretation of such laws. Therefore, the services of a legal or tax advisor should be sought before implementing any ideas contained in this publication. © 2020



440.740.0130 | www.PlannedFinancial.com

7000 Fitzwater Road, Suite 300 | Cleveland, OH 44141

Investment advice offered through Planned Financial Services, a Registered Investment Advisor.

This information is not intended to be a substitute for specific individualized tax advice. We suggest that you discuss your specific tax issues with a qualified tax advisor.